

Private Letter Ruling
Number: 9736039
Internal Revenue Service
JUN 9, 1997

Internal Revenue Service
Department of the Treasury
Washington, DC 20224

Dear Taxpayer:

This responds to your letter dated February 7, 1996, in which your representative submitted a request for rulings on your behalf. Specifically, your representative requested rulings concerning your participation as a general partner in a limited partnership utilizing low-income housing tax credits.

You were created in 1993 to develop housing for low-income individuals. You are recognized as exempt from federal income tax under section 501(a) of the Internal Revenue Code because you are described in section 501(c)(3). Now, you propose to develop a multi-unit single room occupancy facility. It will be funded, in part, with the syndication of low-income housing tax-credits, which have been allocated to a limited partnership in which you are a general partner. You have made a capital contribution of \$406,000 to the partnership.

In connection with the allocation of these tax-credits, a regulatory agreement will be recorded against the property restricting occupancy of 98 percent of the units to individuals whose household income is 50 percent or less of the area's median income. The agreement restricts occupancy of remaining 2 percent of the units to residents whose household incomes are 30 percent or less of the area's median income. In addition, the regulatory agreement restricts rents charged so as to be in compliance with the rent restrictions set forth in section 42(g) of the Internal Revenue Code.

Following syndication, the partners include you, M, and N. You are the managing general partner with a .15 percent partnership interest. M is a co-general partner with a .85 percent partnership interest and is the developer of the project (hereinafter referred to as "developer"). N is the syndicator of the tax-credits and is the investor limited partner (hereinafter referred to as "investor"). The investor has the remaining 99 percent partnership interest.

The Partnership Agreement provides that as managing general partner you will have responsibility for the day-to-day operations. However, the agreement originally provided that your duties would be as determined by the general partners. It specified that your duties as managing partner included advising the partnership on the requirements of low-income families; coordinating with local service agencies; advising the general partners on how to make the project more widely known in the community; consulting with and

identifying needs of the residents; and providing counseling services. However, partnership duties assigned to you and the co-general partner jointly include control over substantive functions including compliance with resident qualifications and rental restrictions. Since the developer controls the general partners interest, it had control over qualification and substantive operation of the partnership. Moreover, management fees are paid to the general partners according to their partnership interest.

Under the Partnership Agreement, the developer is obligated to return funds to the investor if specified contingencies arise including inter alia (1) an allocation differential in which the projected credits exceed the allocated credits, (2) a tax credit shortfall in which projected credits exceed the actual credits, or (3) tax credit recapture. In addition, the developer is obligated to acquire the entire interest of the investor if specified events do not occur on time. You have not agreed to any similar obligations or guaranties.

You will provide services to the partnership which will allow the partnership to carry out your housing objectives. You will be compensated for the performance of these services to the partnership. You will receive the following fees for the performance of these services: a Partnership Supervisory Fee, a Social Services Management Fee, a Development Fee, an Incentive Partnership Management Fee. You will also receive your share of allocations of partnership profits.

As part of the partnership arrangement, you also entered into a Pledge and Security Agreement. Under this agreement, you pledged all of your partnership interests in the partnership including your right to receive any distributions, allocations or payments from the partnership. Furthermore, your pledge would secure a default under the Partnership Agreement including a failure of the developer to return funds to the investor or acquire the entire interest of the investor.

Our concern with the transaction was that it appeared the developer/co-general partner controlled the operation of the partnership. You had only minimal control over the partnership because you held a minority general partnership interest. Your authority under the agreement originally was limited to ministerial and advisory functions. The general power over the partnership was held by the general partners jointly, which you did not control. Under these circumstances you were not in a position to claim that you caused the partnership to carry out your charitable housing program. Accordingly, you were unable to claim the housing provided through the operation of the partnership as your charitable function.

You then amended the Partnership Agreement. The amendments to the Partnership Agreement redistribute control of the partnership. They greatly strengthen your control over the operations of the partnership. To assure that the partnership operates for charitable purposes, you have been delegated substantive authority formerly reserved to the general partners. You now have the authority to use partnership resources to cause the partnership to operate in a manner that will comply with the set-aside requirements, the regulatory agreement, the extended use agreement, and all material provisions of project documents. You also have the authority to cause the project to be managed in a manner

that is in compliance with the set-aside and regulatory agreement. You have retained your authority as managing partner over the day-to-day operations.

Another concern we had with the transaction was your pledge to the investors of all your interest in the partnership including your capital contribution and fees which may become payable to you for the performances of services to the partnership. In addition to indemnifying the investor, this pledge would also benefit the developer because it could be exercised upon the failure of the developer to make good on its guaranties made to the investor. Subsequent to raising our concerns, the Pledge and Security Agreement was terminated.

Based on the foregoing facts you request us to provide the follow rulings:

1. Your acquisition and retention of an interest as a general partner in the Partnership that will develop and own the described apartment complex will not adversely affect your exemption under section 501(c)(3) of the Code.
2. The income derived from your participation in the Partnership and the development and operation of the apartment complex, including the partnership Supervisory Fee, the Social Services Management Fee, Development Fee and your share of allocations of partnership profits, will not constitute unrelated trade or business income under sections 511 through 514 of the Code.

Sections 501(a) and 501(c)(3) of the Code provide, in part, for the exemption from federal income tax of corporations organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(a) of the Income Tax Regulations provides that to be exempt under section 501(c)(3) of the Code an organization must be organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(d)(1) of the regulations provides, in part, that an organization may be exempt under section 501(c)(3) of the Code if it is organized for charitable purposes. However, it is not organized or operated exclusively for a charitable purpose unless it serves a public rather than a private interest. Thus, an organization must establish that it is not organized or operated for the benefit of designated individuals.

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.

Rev. Proc. 96-32, 1996-20 I.R.B. 14, provides that an organization 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. This will ordinarily be satisfied by adopting a government-imposed rent restriction.

Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), 675 F.2d 244 (9th Cir. 1982) holds that an organization's participation as a general partner in a limited partnership would not adversely affect its tax-exempt status under sections 501(a) and 501(c)(3) of the Code where pursuant to an arm's length transaction, one of the charitable general partners sold two-thirds of its half interest in the play to three limited partners. Important to the holding is that the general partner was not obligated to return capital to the investors out of its own funds and that the limited partners have no control over the way the organization manages its affairs and that none of the limited partners are directors or officers of the general partner. The opinion concludes that an interest in a single play is not intrusive or indicative of serving private interests.

Section 511 of the Code imposes a tax on unrelated business taxable income of organizations exempt from federal income tax under section 501(a) and 501(c).

Section 512(a)(1) of the Code defines "unrelated business taxable income" as the gross income derived by an organization from any unrelated trade or business regularly carried on by it, less allowable deductions.

Section 513(a) of the Code defines the term "unrelated trade or business" as any trade or business the conduct of which is not substantially related (aside from the need of such organization for income or funds or the use it makes of profits derived) to the exercise or performance by such organization of the purposes or function constituting the basis for its exemption under section 501.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is substantially related to exempt purposes when the business activity has a substantial causal relationship to the achievement of the exempt purposes.

Section 514(a)(1) of the Code provides that income from debt-financed property that is not related to the organization's exempt function is included as unrelated business taxable income.

Section 514(b)(1) of the Code defines the term "debt-financed property" as any property which is held to produce income with respect to which there is acquisition indebtedness.

Section 514(b)(1)(A) of the Code provides that any property all the use is substantially related (aside from the need of the organization for income or funds) to the exercise or performance by such organization of its charitable purpose constituting the basis for its exemption under section 501 will not be included in the term "debt-financed property."

Section 514(c)(1) of the Code provides, in part, that "acquisition indebtedness" means the unpaid amount of the indebtedness incurred by an organization in acquiring or improving the property.

Section 1.514(c)-1(a)(2) of the regulations in Example (4) provides that earnings realized by a general partner of its distributive share will retain its characterization as if the general partner realized the earnings directly from the source. Thus, distributions of debt financed income of the partnership will be treated as debt financed property of the partners pursuant to section 702(b) of the Code.

Under Plumstead, supra, control by the general partner is an important element in qualification for exemption under section 501(c)(3) of the Code. Because you have amended the Partnership Agreement so that you control the partnership and cause it to provide charitable housing within the meaning of Rev. Proc. 96-32, supra, we are no longer concerned with your control over the partnership.

Furthermore, because you have terminated the Pledge and Security Agreement, we are no longer concerned that charitable assets will be placed at risk for the benefit of the investor or developer. Your operations that constitute participation in the partnership otherwise satisfies the requirements of section 501(c)(3) of the Code.

You will provide management and development services for the partnership on a regular basis. These activities would normally be characterized as a trade or business regularly carried on within the meaning of 513(a) of the Code. The fees for these types of services would ordinarily constitute unrelated business taxable income under section 512, subjecting you to tax under section 511. Since your described housing operations will be regularly carried on by you, exclusion of your management operations will depend on their relationship to your exempt operations.

However, your partnership management and service activities are essential to your ability to provide low-income housing to relieve the poor and distressed. In fact, you would be unable to provide charitable housing without providing these services. Your management activities and service activities assure the operation of the partnership to meet your charitable goals. Notwithstanding that such activities may constitute a trade or business, they are substantially related to your exempt function within the meaning of section 513 of the Code and section 1.513-1(d)(2) of the regulations because they have a substantial causal relationship to your achievement of your exempt purposes.

The partnership will develop the project, in part, with conventional debt. Under section 514(b)(1) of the Code debt-financed property includes property that is held to produce income and with respect to which there is acquisition indebtedness. In turn, acquisition indebtedness is defined in section 514(c)(1) as indebtedness incurred in acquiring or improving the property. Furthermore, a distributive share of earnings from debt-financed partnership property to a partner would be regarded as debt-financed income to the partner pursuant to section 1.514(c)-1(a)(2).

However, as previously described herein the property will be used to provide low-income housing carrying out your exempt function. Thus, rental income from the project is substantially related to the performance of your exempt function within the meaning of Section 514(b)(1)(A).

Based on the forgoing, we rule as follows:

1. Your acquisition and retention of an interest as a general partner in the Partnership that will develop and own the described apartment complex will not adversely affect your exemption under section 501(c)(3) of the Code.
2. The income derived from its participation in the Partnership and the development and operation of the apartment complex, including the Partnership Supervisory Fee, the Social Services Management Fee, and Development Fee will not constitute unrelated trade or business income under sections 511 through 513 of the Code. Furthermore, income derived from your share of allocations of partnership profits, will not constitute unrelated trade or business income under sections 511 and 514 of the Code.

This ruling is based on the understanding that there will be no material changes in the facts upon which it is based and does not reflect or affect any further transactions.

We are informing your key District Director of this ruling and any changes in the facts forming the basis for this ruling should be reported to that office.

This ruling is directed only to the organization that requested it. Section 6110(j)(3) of the Code provides that it may not be used or cited as precedent.

Sincerely,

Garland A. Carter
Chief, Exempt Organizations
Technical Branch 5