

Private Letter Ruling 8927061, IRC Section 42

This letter is in response to your ruling request of January 17, 1989 with respect to the Federal income tax consequences concerning acquisition and retention of a general partnership interest in a limited partnership.

A is a non-profit corporation recognized as exempt under section 501(c)(3) of the Internal Revenue Code. A proposes to become a general partner in a limited partnership (also known as the "project"). This limited partnership will be formed to acquire an existing abandoned school building located in a depressed and deteriorating area for the purpose of rehabilitation and expansion for up to a 213 unit residential room and board facility for low income individuals. Tenants who satisfy the required income levels pursuant to section 42(g) of the Code will be given preference. It is projected that a large number of tenants will be individuals that are low-income, elderly, disabled or blind.

A initially intended to develop, operate and finance the rehabilitation of the abandoned school; however, its failure to obtain sufficient debt financing necessitated its participation in the limited partnership. A's participation in the limited partnership will enable it to obtain much needed equity financing for the project through syndication of historic and low income housing credits.

A currently is the sole general partner owning a 99 percent partnership interest and an individual holds the remaining 1 percent as a limited partner. Both lenders and equity providers of the project expressed concern over A's ability to provide sufficient expertise during the construction phase of the project due to A's lack of knowledge in this area. Thus, it has been proposed that before final closing on the HUD section 232 financing for the project, another organization, which is not exempt from federal taxes, will be brought in as a limited partner along with one or more individuals and/or a for-profit corporation. It is anticipated that the limited partners, collectively, will own a 99 percent interest with a lesser interest upon sale or refinancing.

The limited partners will have no role in the management of the project and the general partner shall have the exclusive management and control of the business of the partnership. A will remain as a general partner owning a 1 percent interest. The switch in A's ownership interest in the partnership from 99 percent to 1 percent or less will occur upon syndication of the partnership. An additional general partner will be brought into the project, at the request of the lenders and will share the 1 percent interest, ultimately to be held by A as the general partner. The additional general partner will be an individual or a for-profit entity who is familiar with real estate construction, development and management.

A may receive up to \$ 1.3 million in developer fees for the activities it will perform. These activities include acquisition, zoning, financing, architectural and design, marketing and ownership structuring. All monies earned will be limited in use to further fulfilling A's exempt purposes.

Section 501(c)(3) of the Code provides for the exemption from federal income tax of organizations that are organized exclusively for religious, charitable, educational, or other specified exempt purposes, no part of the net earnings of which inures to the benefit of any private shareholder or individual.

Section 1.501(c)(3)-1(d)(1)(ii) of the Income Tax Regulations provides that an organization is not organized or operated exclusively for any of the purposes specified in section 501(c)(3) unless it serves a public rather than a private interest. Thus, an organization applying for tax exemption under section 501(c)(3) must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or the creator's family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interest.

Section 1.501(c)(3)-1(d)(2) of the regulations defines charitable, in part, as follows:

The term "charitable" is used in section 501(c)(3) in its generally accepted legal sense and is, therefore, not to be construed as limited by the separate enumeration in section 501(c)(3) of other tax-exempt purposes which may fall within the broad outlines of "charity" as developed by judicial decisions. Such term includes relief of the poor and distressed or of the under-privileged; advancement of religion; advancement of education or science; erection or maintenance of public buildings, monuments, or works; lessening of the burdens of government; and promotion of social welfare by organizations designed to accomplish any of the above purposes, or (i) to lessen neighborhood tensions; (ii) to eliminate prejudice and discrimination; (iii) to defend human and civil rights secured by law; or (iv) to combat community deterioration and juvenile delinquency. The fact that an organization which is organized and operated for the relief of indigent persons may receive voluntary contributions from the persons intended to be relieved will not necessarily prevent such organization from being exempt as an organization organized and operated exclusively for charitable purposes.

Section 1.501(c)(3)-1(c)(2) of the regulations provides that an organization is not operated exclusively for one or more exempt purposes if its net earnings inure in whole or in part to the benefit of private shareholders or individuals.

Section 511 of the Code imposes a tax on the unrelated business taxable income (defined in section 512) of organizations exempt from tax under section 501(a) of the Code.

Section 512 of the Code defines the term "unrelated business taxable income" as the gross income derived by any organization from any unrelated trade or business (defined in section 513) regularly carried on by it, less the allowable deductions which are directly connected with the carrying on of such trade or business.

Section 512(c) of the Code provides that if a trade or business regularly carried on by a partnership of which an organization is a member is an unrelated trade or business with respect to such organization, such organization in computing its unrelated business

taxable income must in general include its share (whether or not distributed) of the gross income of the partnership deductions directly connected with such gross income.

Section 513(a) of the Code provides that the term "unrelated trade or business" means, in the case of any organization subject to the tax imposed by section 511, any trade or business the conduct of which is not substantially related to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption.

Section 1.513-1(d)(2) of the regulations provides that a trade or business is "related" to exempt purposes only where the conduct of the business activities has a causal relationship to the achievement of exempt purposes (other than through the production of income). Further, it is "substantially related", for purposes of section 513, only if the causal relationship is a substantial one. For this relationship to exist, the production or distribution of the goods or the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of exempt purposes. Whether the activities productive of gross income contribute importantly to such purposes depends in each case upon the facts and circumstances involved.

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

Section 514(b)(1)(A)(i) of the Code excludes from the definition of debt-financed property any property substantially all the use of which is substantially related (aside from the need of the organization for income of funds) to the exercise or performance by such organization of the purpose or function constituting the basis for its exemption.

Section 1.514(b)-1(b)(1)(i) of the regulations provides that, in determining whether the exclusion set forth in section 514(b)(1)(A)(i) of the Code is applicable, the principles in section 1.513-1 of the regulations should be applied in determining whether there is a substantial relationship between the property and the exempt purpose of the organization.

Rev. Rul. 69-441, 1969-2 C.B. 115, held that an organization that assists low income individuals and families with individual counseling, and assists them in establishing budget plans where necessary, may be exempt under section 501(c)(3) of the Code.

Rev. Rul. 70-585, 1970-2 C.B. 115, held that an organization formed to engage in a program for new housing construction and the renovation of existing housing for sale to low income families on long-term, low payment plans is exempt under section 501(c)(3) of the Code.

In the instant case, the partnership agreement recognizes that the obligations and responsibilities of A as a general partner are limited. The pursuit of a profit motive cannot be established as a motivating factor for A's participation in this venture. The management fee arrangement is consistent with the pursuit of exempt purposes and the

method of compensation in this case appears to be reasonable because they are related to services rendered. Moreover, the property acquired by A is excluded from the definition of debt-financed because more than 85 percent of the use of this property will be devoted to A's exempt purposes. See section 1.514(b)-1(b)(1)(i) of the regulations. As a direct result of A's participation in this limited partnership, low income and elderly individuals will be able to obtain housing at affordable costs, younger members of the community will be able to secure entry level employment, and local business will participate in the construction of the building. A will also provide an on-the-job training program on a continuous basis. Such a program will be designed to improve literacy and basic employment skills of low-income individuals. These activities will provide relief of the poor and distressed, combat community deterioration and lessen neighborhood tensions. The Service has held that an organization which undertakes these activities is operating exclusively for charitable purposes. See Rev. Rul. 692-441, 1969-2 C.B. 115, and Rev. Rul. 70-585, 1970-2 C.B. 115.

Based on the information submitted, and assuming A will continue to operate as described above, we rule as the follows:

1. The acquisition and retention by A of an interest as a general partner in the limited partnership will not adversely affect its exemption under section 501(c)(3) of the Code, and
2. Income derived from its participation in the partnership, including developer fees, management fees, consulting fees, and income gained on its greater interest on sale or refinancing, will not constitute unrelated trade or business income under section 511 through 514.

No opinion is expressed with respect to the tax treatment of the transaction under the provisions of any other section of the Code or regulations that may also be applicable to it, or to the tax treatment of any conditions existing at the time of, or effects resulting from, the transaction that are not specifically covered by this ruling.

We are informing your key District Director of this ruling. Because this ruling could help resolve future questions about your federal income tax status, you should keep it in your permanent records.

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.

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