DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

[redacted] Release to Manager, EO Determinations - Cincinnati
DATE: [redacted]
SUBJECT: [redacted]

Date: JAN 1 0 2003

Contact Person: [redacted]
Identification Number: [redacted]
Telephone Number: [redacted]

[redacted]
15 [redacted]

Employer Identification Number: [redacted]

Dear Sir or Madam:

We have considered your application for recognition of exemption from federal income tax under section 501(a) of the Internal Revenue Code as an organization described in section 501(c)(3). Based on the information submitted, we have concluded that you do not qualify for exemption under that section. The basis for our conclusion is set forth below.

FACTS:

You were incorporated on May 28, 1999, under the nonprofit laws of the State of [redacted]. The Articles of Incorporation state that you are organized and must be operated exclusively for charitable, scientific or educational purposes within the meaning of section 501(c)(3) of the Code by operating for the benefit of, to perform the functions of, or to carry out the purposes of [redacted] a nonprofit section 501(c)(3) organization. Your Articles of Incorporation state that in furtherance of these purposes, you seek to provide low-income housing facilities and services to elderly persons and promote the health, security, happiness and usefulness in longer living of elderly persons. [redacted] is a licensed intermediate treatment facility providing for [redacted]

You were formed to participate in an affordable housing project that is anticipated to qualify for low-income housing tax credits under section 42 of the Code. To utilize these tax credits you have entered into [redacted] limited liability company ("LLC") with investors. The LLC will be treated as a partnership for federal tax purposes.

[redacted]

LLC plans to construct and operate a 40-unit apartment building in [redacted]. You will serve as the managing member of LLC and will own a [redacted] percent membership interest. For-profit investor members will provide funding for the project, along with loans. The Investor Members are (1) [redacted], an [redacted] for-profit corporation; (2) [redacted], an [redacted] for-profit corporation; [redacted] ("[redacted]"), a [redacted] banking corporation; and [redacted] ("[redacted]"), a [redacted] banking corporation (together, "Investor Members"). The Investor Members will each own a membership interest equal to [redacted] percent. The Investor Members have committed to a combined capital contribution.

Capital contributions of the investor members will be made in installments that will be due only after various stages of development and contingencies are satisfied, such as certain obligations of the managing member being met. All profits and losses will be allocated among the members in accordance with their membership percentages. However, certain special allocations will apply in determining profits and losses among the members and will be made prior to any other distributions.

You represent that upon completion all rental units will be rented exclusively to low-income homeless men who are recovering [redacted]. All of the [redacted] LLC units are single occupancy efficiency units. The [redacted] Housing Corporation sets the maximum income limits and rental rates. Based on the required income and rent limits, you have represented that all of the units in [redacted] LLC will be rented to individuals whose incomes are [redacted] percent or less of the area median income. You further represented that the rental rates of all of the units will be restricted to rent of 84 percent or less of the applicable rent limit established under the tax credit program.

The Amended and Restated Operating Agreement ("Operating Agreement") states a purpose to acquire, construct, own, finance, lease and operate the project property as a qualified low-income housing project under section 42 of the Code and to eventually sell the property.

The project will be managed by [redacted], Inc. under a written management agreement. The Management Agent will receive a fee equal to [redacted] percent of the gross rents and all other operating income generated. The Management Agent handles the funds and must obtain approval for capital improvements exceeding $[redacted] or services exceeding $[redacted]. The Management Agent will maintain a monthly accounting and report on rental activity, to be made available to the owner at any time. The owner approves an annual budget.

[redacted]

In addition to the Management Agent, there will also be an Asset Manager engaged in property management oversight, tax credit compliance monitoring, and related services, who is answerable only to the Investor Members (sec. 5.5(b)) and with whom the Managing Member must cooperate (sec. 5.4(k), 7.1). [redacted] serves as the Asset Manager.

The Managing Member exercises control over the LLC's affairs (sec. 5.1, 6.2), but needs the prior written consent of the Investor Members for a number of activities, including, but limited to: selling any interest in the property (other than lease of residential units); incurring liabilities in excess of $[redacted]; acquiring property for a price of more than $[redacted]; refinancing, prepaying, or modifying any mortgage; compromising any claim or liability in excess of [redacted]; constructing improvements on the property other than contemplated in the Plans and Specifications; encumbering any interest in the property; loaning any money; changing the LLC's purpose; hiring any person to manage the property; executing an assignment for the benefit of creditors (sec. 5.2); and resolving tax matters affecting the rights of the LLC and its members (sec. 5.4(c)(6)). The Managing Member agrees to send to the Investor Members as soon as available all information relevant to the construction and development of the property (sec. 5.3(p)). The Managing Member agrees not to transfer a controlling interest in itself without the consent of the Investor Members, which consent shall not be unreasonably withheld (sec. 5.3(gg)). The signatures of both the Managing Member and Asset Manager are necessary for withdrawals from the Operating Reserve Account to fund operating and debt service deficits (sec. 5.4(g)(1)). Withdrawals from the replacement reserves for capital improvements and repairs are require the Investor Members' approval (sec. 5.4(g)(2)). The Managing Member must deliver to the Investor Members, or make available upon request, LLC bank statements (sec. 5.4(e)), books of account (sec. 7.1), periodic financial statements, including financial/performance reports prepared for government agencies or lenders (sec. 7.2), annual budgets and other information and documentation concerning the LLC's business and financial condition (sec. 7.3(a)), and detailed reports on material defaults, facts which may affect further distributions, and certain other matters (sec. 7.3(b) and (c)). Investor Members have the right to replace the Accountant if the reporting requirements are not met (sec. 7.6(c)). The Investor Members may elect to dissolve the LLC after the Compliance Period (sec. 10.1(d)).

Investor Members have the right to remove the Managing Member for a number of reasons, including: gross negligence or breach of fiduciary duty that has a material adverse effect on the LLC; breach of any covenant; action or inaction that substantially reduces the tax benefits or substantially increases tax liabilities of the Investor Members; construction cost overruns or operating deficits that adversely affect the financial forecasts or viability of the project; loan default; substantial mismanagement; failure to achieve [redacted] percent of projected tax credits for any year; failure to promptly

[redacted]

discharge the management agent if cause exists; and failure to make a required payment to Investor Members of required capital contributions (sec. 9.5). The Managing Member irrevocably appoints the Investor Members and Asset Manager as attorney-in-fact to remove the Managing Member under sec. 9.5 (sec. 9.7). Every agreement entered into by the LLC and the Managing Member must provide that such agreement is terminable at the election of the Investor Members if the Managing Member is removed (sec. 5.5). The Managing Member must remove the Management Agent for cause, including failure to generate [redacted] percent of the tax credits and failure to comply with the record keeping, tenant qualification, and rental requirements under section 42 (sec. 9.7).

The Managing Member is required to make a number of capital contributions, loans, and payments to the Investor Members and LLC under the terms of the Operating Agreement. The Managing Member: assigns all of the rights, title, and interest in any agreements, tax credit allocations, and other personal property related to the project property without any credit to its capital account (sec. 2.1(b)—members otherwise receive capital account increases for contributions of property under sec. 2.5(a)); agrees to make capital contributions to pay the developer note (sec. 2.1(c)); guarantees the performance and payment of obligations of the developer (sec. 5.4(f)(2)); agrees to make interest-free loans to the LLC during the breakeven period to meet all of its reasonable operating and fixed costs(sec. 5.4(h)(1)); agrees to make capital contributions if actual loan proceeds are less than anticipated amounts (sec. 5.4(j)); and agrees to make a capital contribution to compensate the Investor Members in each instance of a permanent reduction, timing difference, or material shortfall in tax credits, plus interest (sec. 2.1(d), 2.10). Upon the occurrence of a number of contingencies relating to failure to operate the housing and generate tax credits as anticipated, the Managing Member agrees to purchase the Investor Members' interests in the amount of all capital contributions made plus expenses incurred by the Investor Members (sec. 5.10(e)). To secure its obligations under the Operating Agreement, the Managing Member pledges all of its interest in the LLC to the LLC and the Investor Members (sec. 9.8).

The LLC borrowed a $[redacted] construction loan from [redacted] which requires the bank's consent for the LLC to borrow funds, reorganize, amend its articles, sell substantially all of its assets, or lease any interest in its assets. In addition to accruing interest on the loan, and all other fees and expenses payable by the LLC to the bank, [redacted] required the LLC to pay a non-refundable loan commitment fee in the amount of $[redacted]. The loan is payable by, and is secured by the property, capital contributions of the members, and assignment of the rents and tax credits.

APPLICABLE LAW:

[redacted]

Section 501(c)(3) of the Code exempts from federal income tax, as provided in section 501(a), organizations organized and operated exclusively for exempt purposes no part of the net income of which inures to the benefit of any private individual or shareholder.

Section 1.501(c)(3)-1(c)(1) of the Income Tax Regulations provides that an organization will be regarded as operated exclusively for one or more exempt purposes only if it engages primarily in activities which accomplish one or more of such exempt purposes specified in section 501(c)(3) of the Code. An organization will not be so regarded if more than an insubstantial part of its activities is not in furtherance of an exempt purpose.

Section 1.501(c)(3)-1(d)(1)(ii) of the regulations provides that an organization is not organized or operated exclusively for one or more exempt purposes unless it serves a public rather than a private interest. Thus, it is necessary for an organization to establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or his family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

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, or of the underprivileged, and the promotion of social welfare by organizations designed to lessen neighborhood tensions, to eliminate prejudice and discrimination, or to combat community deterioration.

Rev. Rul. 98-15, 1998-1 C.B. 718, reasons 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. In evaluating whether an organization that participates in a partnership is operating exclusively for IRC 501(c)(3) purposes, it is necessary to determine whether the organization's participation in the partnership serves its exempt purposes and whether the partnership arrangement permits the organization to act exclusively in furtherance of exempt purposes rather than for the benefit of for-profit partners.

Rev. Proc. 96-32, 1996-1 C.B. 717, provides a safe harbor test that an organization providing housing 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.

[redacted]

In the case of home ownership programs, this requirement will be satisfied by the adoption of a policy that makes the initial and continuing costs of purchasing a home affordable to low and very low-income residents. If this safe harbor is not satisfied, an organization may demonstrate that it relieves the poor and distressed by reference to all the surrounding facts and circumstances. Rev. Proc. 96-32 further provides that no more than incidental private benefit should flow to private individuals.

In the case of Better Business Bureau of Washington, D.C. v. United States, 326 U.S. 279, 283 (1945), the Court stated that "...the presence of a single...[non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of ... [exempt] purposes."

Harding Hospital, Inc. v. United States, 505 F.2d 1068 (6th Cir. 1974), held that an organization seeking a ruling as to recognition of its tax exempt status has the burden of proving that it satisfies the requirements of the particular exemption statute. Whether an organization has satisfied the operational test is a question of fact.

In Redlands Surgical Services v. Commissioner, 113 T.C. 47 (1999), aff'd, 243 F.3d 904 (9th Cir. 2001), the Tax Court held that an organization whose sole activity was participating in partnerships with for-profit partners to operate a surgery center was not operated exclusively for exempt purposes because it had ceded effective control over the operation of the partnerships and surgery center to the for-profit partners and the management company.

In American Campaign Academy v. Commissioner, 92 T.C. 1053 (1989), the court concluded that an organization that trained campaign workers for the benefit of the Republican Party was not exempt under section 501(c)(3) of the Code due to the greater than incidental private benefit to the Party and to Republican Party candidates. The court noted that section 501(c)(3) organizations may benefit private interests only incidentally. Conferring more than incidental benefit on private interests is a nonexempt purpose.

In Plumstead Theatre Society, Inc. v. Commissioner, 74 T.C. 1324 (1980), aff'd, 675 F.2d 244 (9th Cir. 1982), the Tax Court held that a charitable organization's participation as a general partner in a limited partnership did not jeopardize its exempt status. The organization co-produced a play as one of its charitable activities. Prior to the opening of the play, the organization encountered financial difficulties in raising its share of the costs. In order to meet its funding obligations, the organization formed a limited partnership in which it served as a general partner and two individuals and a for-profit corporation were the limited partners. Significant factors in the Tax Court's finding included that the limited partners played a passive role as investors only; that the organization remained in control of all aspects of the play, that none of the limited

[redacted]

partners were directors or officers of the organization, and that the investors' interests in the particular play were not intrusive or indicative of serving private interests.

In Housing Pioneers v. Commissioner, 65 T.C.M. (CCH) 2191 (1993), aff'd, 49 F.3d 1395 (9th Cir. 1995), amended 58 F.3d 401 (9th Cir. 1995), the Tax Court concluded that the organization did not qualify as an organization described in section 501(c)(3) of the Code because its activities performed as co-general partner in limited partnerships substantially furthered nonexempt purposes, and private interests were served by its activities. The organization entered into partnerships as a one- percent co-general partner of existing limited partnerships for the purpose of splitting the tax benefits with the for-profit partner. Under the management agreement, the organization's authority as co-general partner was narrowly circumscribed. It had no management responsibilities and could describe only a vague charitable function of surveying tenant needs.

DISCUSSION

Based upon the above statement of facts and applicable law, we conclude you are not described in section 501(c)(3) of the Code. We reach our conclusions based on the analysis below.

The conduct of activities for purposes described in section 501(c)(3) of the Code must be the exclusive purpose of an organization before it can be recognized as exempt from tax under section 501(a) of the Code. An organization is not operated exclusively for charitable purposes if the benefits to private individuals are more than an incidental consequence of its operations. Section 1.501(c)(3)-1(d)(1) of the regulations.

As demonstrated in Better Business Bureau of Washington, D.C., Inc. v. United States, supra, a single function may actually achieve more than one purpose. If one purpose is nonexempt and substantial in nature, it destroys the exemption regardless of the number or importance of the exempt purposes. Thus, regardless of the fact that you may cause the partnership to provide housing to persons regarded as poor and distressed, you will not qualify for exemption if you have a substantial purpose to benefit the investor members.

In your case, you have but a single function, which is to participate in a limited liability company treated as a partnership for federal income tax purposes that will construct and operate a low-income housing project. Thus, controls that the investor members have over the creation and operation of the joint venture will necessarily detract from your exempt operations. Certain controls that the investor members have under the agreements, in regard to penalty and guaranty provisions, are intrusive.

The LLC arrangement lacks any requirement to place charitable purposes ahead of investment and other commercial objectives, which was a key factor in Redlands and Rev. Rul. 98-15. Instead, the Operating Agreement is designed to maximize and protect the economic interests of the investor members. The Articles of Organization and Operating Agreement are silent with respect to any charitable purpose, and any change requires the investor members' approval. In Redlands, the tax court noted that in that case, the partnership agreement could only be amended if such amendment did not negatively impact the economic objectives of the partners. A purpose to operate a housing project in accordance with section 42 of the Code does not satisfy the requirements to operate the housing project for charitable purposes as required under section 501(c)(3) of the Code, and in accordance with Rev. Proc. 96-32.

Further, Housing Pioneers, Redlands, and Rev. Rul. 98-15 indicate that where a charity's primary activity is conducted through a partnership (or LLC treated as a partnership), then the charity must control the partnership to ensure that operations are conducted in furtherance of charitable purposes. See also Plumstead. If one were to look solely at the Managing Member designation, then one would conclude that you control the LLC. However, an examination of the relevant documents and other facts and circumstances reveal otherwise.

The Operating Agreement allows the Investor Members to effectively assume managerial control over the LLC (through replacement of the Managing Member) upon a number of grounds, including tax credit shortages, breaches of fiduciary duty, and failure to make required payments to the Investor Members. The Agreement also prevents the Managing Member from selling any interest in the LLC property, engaging in financial or legal transactions involving substantial sums, and other actions, without the consent of the Investor Members. Thus, any control you may have over the LLC's daily operations as Managing Member is limited. Moreover, the Redlands court held that the incentive compensation arrangements such as yours for management services provides incentives to maximize profits at the expense of charitable endeavors. Considering the Operating Agreement, as well as the tax credit provisions and other benefits to the for-profit Members discussed herein, we find that you lack the requisite control over the LLC required under Redlands, Housing Pioneers, and Rev. Rul. 98-15. The for-profit partners to whom you have yielded control have economic goals strikingly different from and often in conflict with the charitable goal of providing low-income housing.

Your control over the LLC's daily activity is further diluted by the contract with the for-profit management company and the purse powers of the Asset Manager. The management company is compensated based on a percentage of the LLC's gross income. These facts evidence a substantial profit-making objective and, as the court in

[redacted]

Redlands found, suggest a surrender of effective control by you that is contrary to any charitable purpose.

The LLC is structured largely with the design of generating tax credits and other financial benefits to the Investor Members, to the detriment of charitable interests. The Operating Agreement in effect guarantees a minimum investment return to the Investor Members, at the Managing Member's expense, through a guarantee of tax credits. The Managing Member has responsibility under the Agreement to ensure that the projected tax credits are realized, and can be removed for such failure. The Managing Member also makes other guarantees. Also, under the Operating Agreement, the Managing Member's managing fee is subordinated to its liabilities to the Investor Member and LLC debts, payable only from distributable cash flow or sales and refinancing proceeds. These terms advance the financial interest of the Investor Members and also place your charitable assets at risk. Although Plumstead may permit a charitable organization's operation as a general partner in limited partnerships when specified conditions exist, Housing Pioneers makes it clear that when an organization fails one of the conditions of Plumstead, the organization cannot rely on that case to establish its qualifications. In summary, a substantial purpose of the LLC activities, as in Housing Pioneers, is the production and protection of tax credits and other benefits to the for-profit Investor Members.

CONCLUSION:

Because your activities confer impermissible private benefits to the limited partners, you have not demonstrated that you will be operated exclusively for exempt purposes. Therefore, we conclude that you are not described in section 501(c)(3) of the Code and are not exempt under section 501(a).

Accordingly, contributions to you are not deductible under section 170 of the Code. You must file federal income tax returns on Form 1120.

You have the right to protest this ruling if you believe it is incorrect. To protest, you should submit a statement of your views to this office, with a full explanation of your reasoning. This statement, signed by one of your officers, must be submitted within 30 days from the date of this letter. You also have a right to a conference in this office after your statement is submitted. You must request the conference, if you want one, when you file your protest statement. If you are to be represented by someone who is not one of your officers, that person will need to file a proper power of attorney and otherwise qualify under our Conference and Practices Requirements.

If you do not protest this ruling in a timely manner, it will be considered by the Internal Revenue Service as a failure to exhaust available administrative remedies.

[redacted]

Section 7428(b)(2) of the Code provides, in part, that a declaratory judgement or decree under this section shall not be issued in any proceeding unless the Tax Court, the United States Court of Federal Claims, or the District Court of the United States for the District of Columbia determines that the organization involved has exhausted administrative remedies available to it within the Internal Revenue Service.

If we do not hear from you within 30 days, this ruling will become final and a copy will be forwarded to the Ohio Tax Exempt and Government Entities (TE/GE) office. Thereafter, any questions about your federal income tax status should be directed to that office, either by calling 877-829-5500 (a toll free number) or sending correspondence to: Internal Revenue Service, TE/GE Customer Service, P.O. Box 2508, Cincinnati, OH 45201. The appropriate State Officials will be notified of this action in accordance with Code section 6104(c).

When sending additional letters to us with respect to this case, you will expedite their receipt by using the following address:

Internal Revenue Service
T:EO:RA:T:1
[redacted]
1111 Constitution Ave, N.W.
Washington, D.C. 20224

To help further expedite our handling of this matter, you may fax your response at the following telephone number [redacted]. Please also mail the original of your response to the address listed.

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

We have sent a copy of this letter to your authorized representative as indicated in your power of attorney.

Sincerely,

[redacted]

[redacted]
Manager, Exempt Organizations
[redacted]