

## **K. THE USE OF LIMITED PARTNERSHIPS TO ACCOMPLISH CHARITABLE OBJECTIVES**

### **1. Introduction**

The purpose of this topic is to update and supplement previous CPE discussions concerning the participation of IRC 501(c)(3) organizations in partnerships with nonexempt entities. The use of partnerships involving hospitals and their staff physicians to construct medical office buildings is discussed in the 1981 CPE text at page 4, the 1984 CPE text at page 22, and the 1985 CPE text at page 196. A partnership created to finance theatrical productions is discussed in the 1982 CPE text at page 235. Investment partnership financing of rental housing for senior citizens is discussed in the 1985 CPE text at page 179.

### **2. Background**

In recent years, many IRC 501(c)(3) organizations have sought to raise capital to finance their exempt activities by joining with private investors in limited partnerships. A limited partnership is a type of partnership comprised of one or more general partners who manage the business and who are liable for partnership debts, and one or more limited partners who contribute capital and share in profits but who take no part in running the business and incur no liability with respect to partnership obligations beyond contributions.

The limited partnership in which the exempt organization is a general partner is attractive to that organization for several reasons. First, IRC 501(c)(3) organizations are foreclosed from raising additional funds through the issuance of equity stock. Second, many private investors are reluctant to lend directly to nonprofit entities. Third, the limited partnership enables the IRC 501(c)(3) organization to obtain funds from investors seeking to take advantage of the attractive tax benefits such arrangements may provide.

The limited partnership as a vehicle for carrying on charitable activities has been questioned, however, given the requirement that IRC 501(c)(3) organizations be operated "exclusively" for exempt purposes. It has been suggested that the exempt organization's participation necessarily reflects a substantial nonexempt purpose, i.e., that of furthering the private interests of the limited partners. Moreover, it can be argued that the organization's role as a general partner in the

partnership creates a fiduciary duty to the nonexempt limited partners which is irreconcilable with the "exclusivity" requirement of IRC 501(c)(3).

### 3. The Service Position

#### (A) An Early View

In one of the earliest cases involving the partnership issue to be considered in the National Office, a corporation was organized to assist low and middle income families in obtaining moderately priced housing in a suburban area. The organization planned to construct, under its general management and supervision, a 60-unit housing project with the help of 90 percent government sponsored mortgage financing. The project would be accomplished through the formation of a limited partnership, with the corporation as the sole general partner; the partnership would become the owner of the fully developed rental property.

The Service concluded that the partnership's objectives were not charitable since a large proportion of the rental units was designated for moderate income tenants and the project was not located in an economically depressed area. Thus, the project did not promote social welfare by lessening neighborhood tensions, eliminating prejudice, or combatting community deterioration. Moreover, as the sole general partner, there was a conflict between the exempt organization's fiduciary duty to investors and its charitable purposes. G.C.M. 36293 (May 30, 1975) stated that participation in the partnership:

"...would make the Corporation a direct participant in an arrangement for sharing the net profits of an income-producing venture with private individuals or institutions of a noncharitable nature. Such participation would be inherently incompatible with being operated exclusively for charitable purposes within the meaning of IRC 501(c)(3).

By agreeing to serve as the general partner of the proposed housing project, the Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance practices favoring the equity holdings of the limited partners to a greater extent that would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its

capacity as a general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes."

(B) Facts and Circumstances Approach

In 1980, in light of pending litigation, the Service reexamined the partnership issue. A corporation that was formed to foster the development of low and moderate income housing in a depressed urban area had applied for exemption under IRC 501(c)(3). The organization was a general partner in a limited partnership formed for the purpose of sponsoring a 406-unit multi-family FHA section 236 housing development to be operated on a rental basis. There were two other general partners in the partnership, both for-profit entities. There were also several limited partners whose sole obligation was to contribute capital to the partnership. Under the partnership arrangement, one of the corporation's duties was to represent the objectives of the community, including the tenants of apartments in the housing project, in establishing and formulating tenant selection criteria. Its primary responsibility was to monitor the management of the project and to work with tenant councils and community groups. The Service determined that the arguments against partnership arrangements were based on a conflict of interest analysis and did not, per se, present an independent basis for denial of exempt status. Therefore, if, based on all the facts and circumstances, the organization had the ability to act solely in furtherance of exempt purposes and was not obligated to the pursuit of a profit, a partnership arrangement would not bar exemption under IRC 501(c)(3). In this case, the exemption issue was ultimately conceded.

In Plumstead Theatre Society, Inc. v. Commissioner, 675 F.2d 244 (9th Cir. 1982), the Service argued that a partnership was not structured to preclude a conflict between the organization's fiduciary obligations and its stated exempt purposes. Under the partnership agreement, the organization was obligated to give top priority to the maximization of profits. Under these circumstances, the Service position was that the organization served the substantial private interests of the profit-oriented partners and, accordingly, was not entitled to exemption under IRC 501(c)(3). The Tax Court decision (74 T.C. 1324), however, was in favor of the organization (see the 1982 CPE text at page 237). On appeal the Ninth Circuit, in a per curiam opinion, affirmed the decision of the Tax Court, concluding there was no impermissible serving of private interests. Because neither conflict in the circuits nor administrative importance could be demonstrated, the Service did not recommend that the Department of Justice seek certiorari.

In contrast, G.C.M. 39005 (June 28, 1983) considered an arrangement whereby an exempt organization participated as one of several general partners in a limited partnership for the purpose of constructing, owning, and operating a federally-assisted apartment complex for limited-income handicapped and elderly persons. It was concluded that providing housing for limited-income elderly and handicapped persons served a recognized charitable purpose and that the structure of the partnership, including the presence of non-exempt general partners and federally imposed income limitations, substantially averted conflicts between the organization's exempt goals and its duty to further the pecuniary interests of the other partners. Therefore, the partnership arrangement would not jeopardize the organization's exempt status under IRC 501(c)(3). It was specifically noted in G.C.M. 39005 that,

"[A]n exempt organization's participation in a partnership arrangement as a general partner should not per se result in denial of section 501(c)(3) status. The partnership arrangement, however, should be closely scrutinized to assure that the statutorily-imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. Thus, in all partnership cases, initial focus should be on whether the organization is serving a charitable purpose. Once charity has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners."

(C) Limited Partners within the Exempt Organization's "Control Group"

Consider a ruling request submitted by an IRC 501(c)(3) corporation "A." In order to purchase condominium office space for both itself and a related IRC 501(c)(3) organization "B," A proposes to create a limited partnership with itself as the sole general partner and a number of individuals as the limited partners. As to the make-up of the limited partners, A states, "It is anticipated that a number of the past and present members of the Board of Directors of A and its officers, and others. . . will acquire the limited partnership interest. . ." Under the partnership agreement, the partnership would rent the property to B for a term of 5 years for an amount that represents the fair market value of the property. Approximately 15 to 20 percent of the property would be occupied by A on a rent-free basis with the remaining 80 to 85 percent occupied by B.

By providing office space for a charitable entity A, and for another charitable entity having similar purposes and programs, the partnership arrangement satisfies the threshold requirement of charitability. The partnership agreement, particularly the participation of past and present board members and officers of A as limited partners, would then be scrutinized for potential conflicts of interest between the exempt partner's fiduciary duties to investors and its exempt purposes. Where the limited partners were also in positions of control with respect to the tax-exempt organization, the organization could not be sufficiently "insulated" under the rationale of G.C.M. 39005 without additional constraints being placed on the arrangement. However, the problem could be resolved through the establishment of an independent committee to monitor and oversee the activities of A as the sole general partner. Such committee would consist entirely of individuals who were neither board members nor officers of A.

#### 4. Conclusions

Although the Service at first sought to preclude exempt organizations from participating in partnerships with for-profit investors, the current position is that such arrangements must be examined in light of the facts and circumstances surrounding each case. If the purpose to be achieved is charitable, the partnership arrangement itself should be examined to determine if an impermissible private benefit exists.

In addition to agreements permitting the exempt organization to act exclusively in pursuit of exempt purposes, factors considered to be favorable to the partnership would be:

- Limited contractual liability of the exempt partner.
- Limited rate of return on invested capital of limited partners (stated ceiling that is reasonable under the circumstances).
- Exempt organization's right of first refusal on sale of partnership assets.
- Presence of additional general partners obligated to protect the interests of the limited partners.
- Absence of any obligation to return the limited partner's capital from the exempt organization's own funds.

Unfavorable circumstances would include:

- Disproportionate allocations of profits and/or losses.
- Commercially unreasonable loans by the exempt organization to the partnership.
- Inadequate compensation for services to be provided by the exempt organization.
- Control of the exempt organization by limited partners.

The Service is continuing to examine the compatibility of partnership arrangements with the operational requirements of IRC 501(c)(3). Of particular concern is the ability of exempt partners under state law to effectively insulate themselves from statutorily imposed obligations to the nonexempt partners.