



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

Release Number: **200721025**
Release Date: 5/25/07
Date: March 2, 2007

Contact Person:

Identification Number:

Telephone Number:

Employer Identification Number:

UIL:

501.00-00
511.00-00

Legend:

M =
P =

State =
Date =
County =

x =
y =
z =
aa =

Dear _____ :

This letter supersedes our ruling issued January 30, 2007 regarding your ruling request dated May 16, 2006 and amended on January 11, 2007 requesting a ruling that a proposed change will not adversely affect your tax-exempt status under section 501(c)(3) of the Internal Revenue Code.

FACTS

M is a State not-for-profit corporation incorporated on Date. M's board of directors consists of nine directors: one the director of P, one appointed by a county in State, one appointed by the governor of State, two by the chamber of commerce and another by a private sector organization. The remaining directorships are filled by either the governor of the State or by the board itself.

M's principal activity is a state-wide program offering settlement assistance of up to \$x to low and moderate-income families to obtain mortgages from participating lenders or to purchase homes at approved subdivisions (the "Program"). The Program may also be used for affordable, newly constructed residences. In addition, financial institutions may apply to P for

set-asides.

The Program provides mortgage assistance up to a maximum of \$x in the form of a second mortgage in circumstances where the applicant might otherwise qualify for a mortgage to acquire a home but for the down payment requirement. A borrower must contribute a minimum of \$aa toward the home purchase price. The borrower must participate in a housing counseling program approved by P. The first mortgage must be a 30-year fixed rate mortgage, FHA-insured or a USDA Rural Development Guaranteed Loan for the maximum amount that the borrower is qualified to borrow. The home must be owner-occupied, but the borrower does not need to be a first time homebuyer.

The second mortgage is a lien against the property and neither interest nor principal on these second mortgage loans is payable currently. Payment is deferred until the home is sold or ceases to be the borrower's principal residence. At such time, payment is due in full, with accrued interest. However, if the appreciation on the home is less than twice the amount of the accrued interest on the second mortgage loan, the portion of accrued interest which exceeds one-half of the appreciation is forgiven. The balance of accrued interest and the principal of the loan remain payable.

M promotes the Program through direct communications with the public as well as through a group of participating lenders. All Program loans are made through a group of participating lenders which have been approved by M in accordance with Program guidelines. The participating lender originates a second mortgage loan under the Program along with the first mortgage loan on the residence. The first mortgage loan is an independent transaction between the residential borrower and the lender.

To date, one-third of M's funding has come from State and County. The remaining funds come from charitable foundations and businesses within State. M states that none of the contributions from business entities are in any way associated with benefits received under the Program. In addition, no contributions have been received from developers of any approved residential projects. M acknowledges that several financial institution contributors have some relationship to participating lending institutions under the Program; however M states that such relationship is part of the overall community development and not for any benefit obtained through the Program.

All operations of the Program are undertaken by P, an executive agency of State. P is the exclusive source for all participation in the Program and approves all participating lenders and developers subject to criteria intended to program the Program objectives. P provides a single-family mortgage program as well as a down payment assistance program for new construction and existing residential residences. The director of P is responsible for supervising and controlling all of the business and affairs of M. All of the operating staff support for M is provided by P and all of the general administrative costs are paid by P.

The Program limits participation by family income limits and purchase price limits. M states that historically, the program has utilized the maximum household income limits based on y% of the area median income as determined under HUD guidelines. Although the Program is widely promoted by P and the authorized participating lenders, M continues to have excess funds that

are available but unused by potential applicants under the present income and purchase limits.

Under the current guidelines, M has available but unused funds. M proposes to alter its Program guidelines to allow the maximum family income limits to be the same as those used by P in its single-family housing program. The income limitation under P's single-family program is z% of area median income. M states that the proposed change would allow increased utilization of funds for its down payment assistance program and as an additional resource for P's single-family mortgage program and down payment assistance program. The proposed change is also intended to allow P to operate all of the State housing programs in a coordinated fashion.

RULINGS REQUESTED

You have requested a ruling on whether the implementation of the proposed change to your Program will adversely affect your tax-exempt status under section 501(c)(3) of the Internal Revenue Code and whether such proposed change constitutes an unrelated trade or business under section 513(a) of the Code and subject to tax under section 511 of the Code.

LAW

Section 501(c)(3) of the Code provides, in part, that an organization that is organized and operated exclusively for charitable purposes is exempt from federal income tax.

Rev. Rul. 70-585, 1970-2 C.B. 115, discusses four examples of organizations providing housing and whether each qualified as charitable within the meaning of section 501(c)(3) of the Code. Situation 1 describes an organization formed to construct new homes and renovate existing homes for sale to low-income families who could not obtain financing through conventional channels. The organization also provides financial aid to eligible families who do not have the necessary down payment. When possible, the organization recovered the cost of the homes through very small periodic payments, but its operating funds were obtained from federal loans and contributions from the general public. The revenue ruling holds that by providing homes for low-income families who otherwise could not afford them, the organization relieved the poor and distressed.

Situation 2 describes an organization formed to ameliorate the housing needs of minority groups by building housing units for sale to persons of low and moderate income on an open-occupancy basis. The housing is made available to members of minority groups who are unable to obtain adequate housing because of local discrimination. The housing units are located to help reduce racial and ethnic imbalances in the community. As the activities were designed to eliminate prejudice and discrimination and to lessen neighborhood tensions, the revenue ruling holds that the organization was engaged in charitable activities within the meaning of section 501(c)(3) of the Code.

Situation 3 describes an organization formed to formulate plans for the renewal and rehabilitation of a particular area in a city as a residential community. The median income level in the area was lower than in other sections of the city and the housing in the area was generally old and badly deteriorated. The organization developed an overall plan for the

rehabilitation of the area; it sponsored a renewal project; and involved residents in the area renewal plan. The organization also purchased apartment buildings that it rehabilitated and rented at cost to low and moderate income families with a preference given to residents of the area. The revenue ruling holds that the organization is described in section 501(c)(3) of the Code because its purposes and activities combated community deterioration.

Situation 4 describes an organization formed to alleviate a shortage of housing for moderate-income families in a particular community. The organization planned to build housing to be rented at cost to moderate-income families. The Service held that the organization failed to qualify for exemption under section 501(c)(3) of the Code because the organization's program did not provide relief to the poor or further any other charitable purpose within the meaning of section 501(c)(3) and the regulations.

Rev. Proc. 96-32, 1996-1 C.B. 717, sets forth a safe harbor under which organizations that provide low-income housing are considered charitable as relieving the poor and distressed, and a facts and circumstances test that applies in determining whether organizations that fall outside the safe harbor relieve the poor and distressed. The safe harbor requires that certain percentages of the units be occupied by residents that meet certain low-income standards, and that the housing is affordable to the charitable beneficiaries. In the case of rental housing, this requirement will ordinarily be satisfied by the adoption of a rental policy that complies with government-imposed rental restrictions or otherwise provides for the limitation of the tenant's portion of the rent charged to ensure that the housing is affordable to low-income and very low-income residents. Relevant facts and circumstances under the facts and circumstances test may include, but are not limited to, the following:

1. A substantially greater percentage of residents than required by the safe harbor with incomes up to 120 percent of the area's very low-income limit.
2. Limited degree of deviation from the safe harbor percentages.
3. Limitation of a resident's portion of rent or mortgage payment to ensure that the housing is affordable to low-income and very low-income residents.
4. Participation in a government housing program designed to provide affordable housing.
5. Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations.
6. The provision of additional social services affordable to the poor residents.
7. Relationship with an existing 501(c)(3) organization active in low-income housing for at least five years if the existing organization demonstrates control.
8. Acceptance of residents who, when considered individually, have unusual burdens such as extremely high medical costs which cause them to be in a condition similar to persons within the qualifying income limits in spite of their higher incomes.
9. Participation in a homeownership program designed to provide homeownership opportunities for families that cannot otherwise afford to purchase safe and decent housing.
10. Existence of affordability covenants or restrictions running with the property.

Rev. Rul. 2006-27, I.R.B. 2006-21, May 4, 2006, sets forth guidance in connection with organizations that provide down payment assistance. The ruling discusses three situations:

Situation 1 describes an organization that, as a substantial part of its activities provides down payment assistance exclusively to low-income individuals and families to provide part or all of the funds they need to make a down payment on the purchase of a home. The process for awarding grants is structured to ensure that the organization does not know the identity of the party selling the home or the identities of any other parties, and it rejects any contributions that are contingent on the sale of a particular property or properties. In addition, the organization offers financial counseling seminars and conducts other educational activities to help prepare potential low-income homebuyers for the responsibility of homeownership, requires home inspection reports to ensure the habitability of the residence. Finally, the organization conducts a broad based fundraising program that attracts gifts, grants, and contributions from several foundations, businesses, and the general public.

Situation 2 describes an organization similar to that in Situation 1, except that the organization knows the identity of the selling party as well as the identities of the parties to the transaction. In substantially all cases where the organization provides the down payment assistance, it receives a payment from the seller, and there is a direct correlation between the amount of the down payment assistance provided in each transaction and the amount of the home seller's payment to the organization. Further, the organization does not conduct a broad based fundraising campaign to attract financial support; rather, most of the organization's support comes from home sellers and real estate related businesses that may benefit from the sale of homes to buyers who receive the down payment assistance.

Situation 3 describes an organization similar to that in Situation 1, except that the purpose of the organization is to combat community deterioration in an economically depressed area and the organization provides down payment assistance to low and moderate income families.

The ruling concludes that the organization in Situation 1 qualifies for exemption under section 501(c)(3) of the Code because it operates in a manner consistent with Rev. Rul. 70-585, Sit. 1 and does not operate for private benefit. Similarly, although the organization in Situation 3 does not limit its down payment assistance to low-income recipients, the organization qualifies for exemption because it combats community deterioration and it does not operate for private benefit. However, the organization in Situation 2 does not qualify for exemption under section 501(c)(3) because it does not operated exclusively for exempt purposes.

Section 511 of the Code imposes an income tax on the unrelated business taxable income of an organization recognized as exempt under section 501(c)(3).

Section 512(a)(1) of the Code defines "unrelated trade or business" as the gross income derived by any 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 meaning 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 (aside from the need of organization for income or funds or the use it makes of the profit derived) to the exercise or performance by such organization of its charitable, educational, or other purpose or function constituting the basis for its exemption under section 501 (or in the case of an organization described in section

511(a)(2)(B)), to the exercise or performance of any purpose or function described in section 501(c)(3).

Section 1.513-1(d)(2) of the Income Tax Regulations provides that a trade or business is “related” to exempt purposes only where the conduct of the business activities has 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 the performance of the services from which the gross income is derived must contribute importantly to the accomplishment of those purposes. Whether activities productive of gross income contribute importantly to the accomplishment of any purpose for which an organization is granted exemption depends in each case upon the facts and circumstances involved.

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 for which 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 of the Code 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.

ANALYSIS

The implementation of the proposed change in the Program to allow for higher household income limits, which will increase the limits in excess of y% will not adversely affect M’s exempt status.

While the proposed change will likely exceed the safe harbor described in Rev. Proc. 96-32, the facts and circumstances described indicate that M’s activities will continue to be charitable. The degree of deviation from the safe harbor percentages is not overly large and the Program is designed to provide homeownership opportunities to families that cannot otherwise afford to purchase safe and decent housing. In addition to family income limits, there are limitations on the purchase price. M acknowledges that some funding may be derived from parties other than developers involved in transactions with the Program. However, most of the funding for the Program comes from a broad base including state and local government, private foundations, and other charitable organizations. Finally, by operating in conjunction with P, the Program can be used in coordination with other governmental housing programs.

The proposed Program structure and operations differ from those described in Rev. Rul. 2006-

27. Under the facts provided, M's program is operated in a manner similar to that in Situation 1 of the ruling. Rather than providing funds to a homebuyer as a down payment, the Program provides down payment assistance in the form of a second mortgage. The Program requires that a 30-year fixed rate first mortgage be obtained on the property and borrowers are required to participate in home counseling as well as contribute their own funds towards the purchase of the home as qualification for the second mortgage program. The terms of the loan reflect the charitable aspects of the Program in that repayment of the loan is deferred for a substantial period with an element of debt forgiveness, if the sale of the property generates insufficient funds. The facts provided indicate that there is no coordination between the provision of second mortgages and contribution from sellers.

As discussed above, the provision of second mortgage loans under the Program is related to the exempt purposes of M and therefore, the revenues received in connection with such loans will not be unrelated business taxable income for purposes of section 511 of the Code.

CONCLUSION

Based on the foregoing facts and circumstances, we rule that the implementation of the proposed change to your Program will not adversely affect your tax-exempt status under section 501(c)(3) of the Internal Revenue Code and such proposed change does not constitute an unrelated trade or business under section 513(a) of the Code nor is subject to tax under section 511 of the Code.

This ruling will be made available for public inspection under section 6110 of the Code after certain deletions of identifying information are made. For details, see enclosed Notice 437, *Notice of Intention to Disclose*. A copy of this ruling with deletions that we intend to make available for public inspection is attached to Notice 437. If you disagree with our proposed deletions, you should follow the instructions in Notice 437.

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

This ruling is based on the facts as they were presented and on the understanding that there will be no material changes in these facts. Because it could help resolve questions concerning your federal income tax status, this ruling should be kept in your permanent records.

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

Sincerely,

Debra J. Kawecki
Manager, Exempt Organizations
Technical Group 2

Enclosure
Notice 437