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PROTECTING THE TAX-EXEMPT STATUS OF HOUSING DEVELOPERS PARTICIPATING IN LOW-INCOME HOUSING TAX CREDIT PARTNERSHIPS

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Abstract: The Low-Income Housing Tax Credit (LIHTC) is an important source of federal funding for developers of affordable housing for low-income persons. Although for-profit and nonprofit developers compete for credits, the federal government reserves ten percent of the credits for nonprofit, tax-exempt developers. Exempt developers often sell the credits to for-profit investors, forming a partnership through which the exempt organization develops the housing and the investors receive tax benefits in exchange for capital contributions. The partnership formation, however, may jeopardize the tax-exempt status of the nonprofit organizations and result in the partnership losing the LIHTC. To maintain exempt status, the Internal Revenue Code requires that organizations be organized and operated to promote a charitable purpose and that no net earnings inure to private individuals. A combination of binding and non-binding authority provides confusing guidelines for exempt organizations seeking to protect their exempt status. This Comment examines the federal requirements for the award of LIHTC and traces the development and application of a two-prong test used by the Internal Revenue Service to determine whether partnership structures jeopardize exempt status. This Comment argues that exempt developers in LIHTC partnerships need binding authority that details the level of control of partnership activities the exempt organization must retain, provides an exception for certain partnership guarantees by exempt organizations that are standard within the development industry, and allows investors to receive private benefits to a greater degree without jeopardizing the organization's exempt status.

The Low-Income Housing Tax Credit (LIHTC)[1] provides federal tax incentives to encourage private investors to contribute funding for developing housing for low-income households.[2] Since its inception in 1986, the successful program has become the primary source of funding for low-income housing development.[3] Nearly $300 million in credits[4] are available annually for both for-profit and tax-exempt developers of housing for tenants with below average incomes.[5] Although both for-

1. 26 U.S.C. § 42 (1994).

2. Jonathan Klein & Roberta Rubin, *Nonprofit Guaranties in Tax Credit Transactions*, 9:1 J. AFFORDABLE HOUSING 92, 94 (1999).

3. *See* The Enterprise Foundation, *Low-Income Housing Tax Credit—Our View*, *at* http://www.enterprisefoundation.org/policy/lihtcourview.asp (last visited Jan. 29, 2001).

4. Lynn Kawecki & Marvin Friedlander, *Recent Developments in Housing Regarding Qualification Standards and Partnership Issues*, *in* IRS EXEMPT ORGANIZATIONS CPE TECHNICAL INSTRUCTION PROGRAM TEXTBOOK Part II(2)(B) (1995).

5. Funding provides nearly 70,000 housing units. Michael Novogradac, *Low-Income Housing Tax Credit: Proposals for the Next Century*, 9:1 J. AFFORDABLE HOUSING 104, 108 (1999).

profit and exempt developers compete for credits, the program maintains a preference for exempt developers by reserving ten percent of the total credits for tax-exempt organizations.[6]

Tax-exempt, low-income housing developers generally do not owe taxes and cannot directly use credits.[7] Exempt developers, therefore, sell the credits to for-profit investors who use the credits to reduce their tax liabilities.[8] In addition to the credits, the for-profit investors gain an ownership interest in the project.[9] In general, the project is structured as a limited partnership in which the exempt organization serves as the general partner[10] and retains a one percent interest, while the investors serve as limited partners,[11] obtaining a ninety-nine percent interest in the partnership profits, losses, deductions, and credits.[12] As general partner, the exempt organization assumes the partnership liabilities. To qualify for exempt status, the exempt organization must maintain control of the day-to-day activities of the partnership to demonstrate that it is furthering its exempt purpose.[13]

The resulting partnership may jeopardize the tax-exempt status of the nonprofit developer, which in turn will make the partnership ineligible to use the LIHTC reserved for exempt organizations. The Internal Revenue Code (Code) and corresponding Treasury regulations detail the requirements for federal tax exemption.[14] An organization may receive and retain exempt status upon a showing that a charitable purpose was the primary motivation for forming the organization and that such purpose is furthered by the daily operations of the organization.[15] To

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6. *See* 26 U.S.C. § 42(h)(5)(A) (1994).

7. MICHAEL I. SANDERS, JOINT VENTURES INVOLVING TAX-EXEMPT ORGANIZATIONS § 12.2(c), at 417 (2d ed. 2000).

8. *Id.* The credits attract investors who purchase them for a reduced price. For example, in 1995, credits sold for forty to sixty cents on the dollar. Kawecki & Friedlander, *supra* note 4, at Part II(2)(B).

9. SANDERS, *supra* note 7, § 1.5, at 7.

10. A general partner in a limited partnership has the liabilities of a partner in a partnership. Uniform Limited Partnership Act § 403, 6A U.L.A. 177 (1995). A partner is "liable jointly and severally for all obligations of the partnership unless otherwise agreed . . . ." Uniform Partnership Act § 306, 6 U.L.A. 45 (1995).

11. A limited partner is "not liable for the obligations of a limited partnership unless . . . he participates in the control of the business." Uniform Limited Partnership Act § 303, 6A U.L.A. 144 (1995).

12. SANDERS, *supra* note 7, § 12.2(c), at 418.

13. *Id.* § 1.7, at 10.

14. 26 U.S.C. § 501(a)–(c)(3) (1994); 26 C.F.R. § 1.501(c)(3) (2000).

15. 26 C.F.R. § 1.501(b)–(c).

determine whether the partnership between the for-profit investors and exempt developer violates the requirements of the Code for retaining exempt status, the Internal Revenue Service (IRS) developed a two-pronged "strict scrutiny" test.[16] The test focuses on the organization's charitable purpose and control of the venture, as well as any resulting private benefits.[17]

An examination of federal requirements for exempt status, General Counsel Memorandums,[18] Private Letter Rulings,[19] Revenue Rulings,[20] and limited case law suggests that many LIHTC partnership agreements actually place the exempt status of organizations at risk. In 1995 the Ninth Circuit, in *Housing Pioneers, Inc. v. Commissioner*,[21] revoked the tax-exempt status of an organization engaged in an LIHTC partnership based on the exempt organization's lack of control over partnership activities.[22] In the following two years, the IRS issued three non-binding Private Letter Rulings stating that guarantees committing an exempt organization's assets to protect the assets of the for-profit investor would produce an impermissible private benefit resulting in a loss of exempt status.[23]

Currently, many uncertainties exist about the degree of control the exempt developer must retain over the partnership, the types of guarantees[24] the exempt developer can provide to the partnership, and the types of benefits that can be gained by for-profit investors without

16. Gen. Couns. Mem. 39,005 (June 28, 1983).

17. *Id.*

18. A General Counsel Memorandum (GCM) provides advice on a specific substantive or procedural tax issue. Internal Revenue Manual (37) 121 § 1(b) (1983). GCMs are for research purposes for the Internal Revenue Service (IRS) and are not statements of the IRS's position on issues. *Id.* § (1)(c).

19. A Private Letter Ruling (PLR) is a written statement to a taxpayer interpreting and applying tax law to a set of facts. Rev. Proc. 2000-1, 2000-1 I.R.B. 11. Taxpayers may rely on PLRs responding to their specific inquiries, but may not rely on another taxpayer's PLR. *Id.*

20. A Revenue Ruling is the IRS's conclusion on how a law is applied to specific facts. *Id.* at 11. Revenue Rulings are not binding precedent on the Tax Court but may acquire the force of law if the ruling details accepted administrative practices. Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1070 (1989). Taxpayers may rely on Revenue Rulings when the facts of the taxpayer's situation are similar. *Id.*

21. 58 F.3d 401 (9th Cir. 1995).

22. *Id.* at 404.

23. *See* Priv. Ltr. Rul. 97-36-039 (June 9, 1997); Priv. Ltr. Rul. 97-31-038 (May 7, 1997); Priv. Ltr. Rul. 96-16-005 (Dec. 19, 1995).

24. Due to the lack of assets of exempt organizations, investors often seek indemnities and guarantees obligating the exempt organization to use available assets to make additional capital contributions or cover unforeseen costs. Klein & Rubin, *supra* note 2, at 92.

sacrificing the developer's exempt status. The confusion for organizations in LIHTC partnerships seeking to protect their exempt status is due to a combination of binding and non-binding authority, each applying one or more of several tests to a variety of types of partnerships.

The IRS must give clear guidance to exempt organizations in LIHTC partnerships. Those partnerships that received credits shortly after the program was established in 1986[25] will realize the end of the minimum fifteen-year compliance period[26] in 2001. If the IRS determines that the exempt organizations have jeopardized their status, the partnerships will be ineligible for the LIHTC and ultimately the development of housing for low-income persons will decline.

Part I of this Comment examines the federal requirements both for the award of LIHTC for financing housing for low-income persons and for exempt status under § 501(c)(3) of the Code based on the creation and commitment to a charitable purpose. Part II details the development of the two-part "strict scrutiny" test for determining whether the exempt status of an organization in a partnership is at risk. Part III explains that the current law surrounding exempt-status determinations of organizations in partnerships does not offer clear guidance to nonprofit developers in LIHTC partnerships. Part IV argues that the IRS should issue a Revenue Procedure[27] as binding authority providing guidance to exempt developers using the LIHTC. In particular, the IRS should address control over daily management activities and ultimate voting control, guarantees by the developer that are standard in the industry but may place charitable assets at risk, and the degree to which private benefit may inure without adversely affecting the organization's exempt status.

I. TO QUALIFY FOR THE LIHTC EXEMPT DEVELOPERS MUST SATISFY ELIGIBILITY CRITERIA AND EXEMPT-STATUS REQUIREMENTS

To qualify for the ten percent LIHTC set-aside, exempt developers must comply with the Internal Revenue Code requirements governing

25. *See* SANDERS, *supra* note 7, § 12.2(a), at 416.

26. Recipients of the LIHTC must maintain reduced rents for fifteen years. 26 U.S.C. § 42(i)(1) (1994).

27. A Revenue Procedure outlines the internal practices and procedures of the IRS in administering tax laws. WILLIAM RAABE ET AL., WEST'S FEDERAL TAX RESEARCH 96 (4th ed. 1997).

eligibility for receipt of the LIHTC and exemption from federal income tax. Exempt developers of housing for low-income persons are eligible for the LIHTC if they commit to serving low-income households[28] for a minimum of fifteen years,[29] retain an ownership interest in the partnership, and actively participate in the management and operation of the project.[30] An organization developing housing for low-income persons is eligible for exemption from federal income taxation upon proof that the organization was created to and continues to further a charitable purpose without providing a private benefit to any individual or entity.[31]

A. *Qualification Requirements for Exempt Organizations Applying for LIHTC*

The federal government allocates the LIHTC to designated state agencies to award credits to developers of housing for low-income families.[32] Because they generally owe no taxes and cannot directly use the tax credits,[33] tax-exempt recipients may sell the credits to private investors who reduce their tax liabilities over a ten-year period.[34] This transaction generally results in the formation of a partnership between the exempt "developer" and the for-profit "investor."[35] To be awarded and maintain the credits, a recipient must comply with various Code requirements. First, the Code requires that projects receiving credits restrict unit rental to households with below-average incomes and limit rental prices to less than thirty percent of the household's monthly income.[36] Second, developers must maintain these rent restrictions for a minimum compliance period of fifteen years.[37] The recipient must also

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28. 26 U.S.C. § 42(g).

29. *Id.* § 42(i)(1).

30. *Id.* § 42(h)(5)(B).

31. *See id.* § 501(a)–(c)(3).

32. *See* SANDERS, *supra* note 7, § 12.2(d), at 423.

33. *Id.* § 12.2(c), at 417.

34. *See* 26 U.S.C. § 42(f)(1).

35. *See supra* notes 9–12 and accompanying text. This Comment refers to a nonprofit partner as a "developer" and a for-profit partner as an "investor."

36. 26 U.S.C. § 42(g). For income limits in each metropolitan area see generally U.S. DEPARTMENT OF HOUSING AND URBAN DEVELOPMENT, FY 2000 HUD INCOME LIMITS: BRIEFING MATERIAL (2000). HUD defines "low-income" as below eighty percent of the area's median income. *Id.* at 1.

37. 26 U.S.C. § 42(i)(1).

agree to an extended low-income commitment[38] providing further protections to low-income residents including an additional fifteen-year obligation to maintain the restricted rents[39] and a prohibition on the refusal to rent to tenants receiving federally subsidized housing assistance.[40] Finally, the nonprofit organization must "materially participate in the development and operation of the project throughout the compliance period."[41] An exempt organization will generally satisfy the "material participation" requirement if it serves as the general partner of the partnership owning the project.[42]

Although the LIHTC qualification criteria are the same for both for-profit and nonprofit developers, the Code states a preference for allocating credits to exempt organizations.[43] In particular, the Code requires that states award at least ten percent of the total credits to projects sponsored by "qualified nonprofit organizations."[44] The Code provides a three-part definition for "qualified nonprofit organizations." First, the organization must have § 501(c)(3) status.[45] Second, the organization may not be "affiliated with" or "controlled by" a for-profit organization.[46] Finally, one of the exempt purposes of the organization must be "fostering" low-income housing.[47]

B. *Exempt Developers Awarded the LIHTC Must Demonstrate that They Were Created for and Continue To Further Charitable Purposes*

Organizations meeting the requirements of the Code and the corresponding Treasury Department Regulations (Regulations) may apply for exemption from federal income tax. Section 501 of the Code provides for exemption of certain organizations that were created to and continue to further charitable purposes.[48] The regulations provide a

38. *Id.* § 42(h)(6)(A).
39. *See id.* § 42(h)(6)(B)(i).
40. *Id.* § 42(h)(6)(B)(iv).
41. *Id.* § 42(h)(5)(B).
42. SANDERS, *supra* note 7, § 12.2(d), at 424.
43. *See* 26 U.S.C. § 42(h)(5)(A).
44. *Id.* § 42(h)(5)(C).
45. *Id.* § 42(h)(5)(C)(i); *see also infra* Part I.B.
46. 26 U.S.C. § 42(h)(5)(C)(ii).
47. *Id.* § 42(h)(5)(C)(iii).
48. *Id.* § 501(a)–(c)(3).

definition for "charitable" purposes and detail methods for determining whether an organization is organized and operated for such purposes.[49]

1. *The Code Establishes the Eligibility Requirements for Exempt Status*

Organizations receive exemption from federal income taxation under § 501(a) of the Code if they meet the requirements detailed in § 501(c).[50] Developers of housing for low-income persons apply for exemption as charitable organizations under § 501(c)(3).[51] To qualify, a developer must be "organized and operated exclusively for . . . charitable . . . purposes . . . [and] no part of the net earnings of [the developer may inure] to the benefit of any private shareholder or individual."[52] If the organization profits from activities not related to its charitable purpose, it will be taxed on that portion of its income[53] and may lose its exempt status.[54]

2. *Treasury Regulations Define Key Terms Relating to Tax-Exempt Status Determinations*

The Regulations provide binding authority for interpreting the requirements of § 501 of the Code. First, the Regulations exempt developers of housing for low-income persons if they have a "charitable" purpose under the Code.[55] For example, relief of the "poor and distressed or of the underprivileged" is a charitable purpose.[56] Another charitable purpose is the promotion of social welfare by organizations designed to "i) lessen neighborhood tensions; ii) to eliminate prejudice and discrimination; . . . [and] iv) to combat community deterioration . . . ."[57]

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49. 26 C.F.R. § 1.501(c)(3) (2000).

50. 26 U.S.C. § 501(a).

51. *Id.* § 501(c)(3).

52. *Id.*

53. *Id.* § 501(b).

54. Tax-exempt organizations will lose exempt status if more than an insubstantial part of their activities are not charitable. *See generally* 26 C.F.R. § 1.501(c)(3).

55. *See id.* § 1.501(c)(3)–1(d)(1)(b).

56. *Id.* § 1.501(c)(3)–1(d)(2).

57. *Id.*

In addition to having a charitable purpose, a developer seeking exempt status must satisfy the organizational test detailed in the Regulations.[58] Under this test, an organization's articles of organization[59] must establish a charitable purpose,[60] obligate the organization to further an exempt purpose as its primary activity, and dedicate the assets to a charitable purpose upon dissolution of the entity.[61] In particular, the articles must limit the purposes of the organization to one or more exempt purposes and prohibit the organization from engaging in activities that do not further an exempt purpose unless such activities are insubstantial.[62] Even if the members orally commit or the actual activities of the organization operate to further one or more exempt purpose, a developer will fail the organizational test if the articles do not obligate the organization to further its exempt purpose.[63]

Finally, an organization seeking exempt status must also operate exclusively for one or more exempt purposes.[64] The organization will not meet this test if more than an insubstantial part of its activities does not further an exempt purpose.[65] If an organization operates to further an exempt purpose but substantially engages in another activity with a non-exempt purpose, it will fail the operational test and be ineligible for exempt status. Another factor used in determining if the operational test is met is whether an organization's "net earnings inure in whole or in part to the benefit of private shareholders or individuals."[66] Private shareholders or individuals have a "personal and private interest in the activities of the organization."[67]

Nonprofit organizations seeking to use the LIHTC to develop housing for low-income households must comply with federal requirements for

58. *Id.* § 1.501(c)(3)–1(a).

59. The term "articles of organization" refers to any instrument written to create the organization. *Id.* § 1.501(c)(3)–1(b)(2).

60. *Id.* § 1.501(c)(3)–1(b)(1)(i)(a).

61. *Id.* § 1.501(c)(3)–1(b). In addition, tax-exempt organizations may not be organized to influence legislation or participate in political campaigns. *Id.* § 1.501(c)(3)–1(b)(3).

62. *Id.* § 1.501(c)(3)–1(b)(1)(a) to (b). "Neither the Internal Revenue Code, the regulations, nor the case law provide a general definition of 'insubstantial' for purposes of section 501(c)(3)." Living Faith, Inc. v. Comm'r, 950 F.2d 365, 371 (7th Cir. 1991).

63. 26 C.F.R. § 1.501(c)(3)–1(b)(1)(b)(iv).

64. *Id.* § 1.501(c)(3)–1(a)(1).

65. *Id.* § 1.501(c)(3)–1(c)(1); *see also* Better Bus. Bureau of Wash. D.C., Inc. v. United States, 326 U.S. 279, 283 (1945) ("The presence of a single [non-exempt] purpose, if substantial in nature, will destroy the exemption regardless of the number or importance of truly [exempt] purposes.").

66. 26 C.F.R. § 1.501(c)(3)–1(c)(2).

67. *Id.* § 1.501(a)–1(c).

the award of LIHTC and for exempt status under the Code. To receive the credits, an organization must commit to restricting rents for thirty years[68] and to participating in the operation of the project.[69] The organization must also maintain its § 501(c)(3) status.[70] The Code requires that the organization have a charitable purpose and that it be organized and operated further that purpose.[71]

II. IRS AND JUDICIAL DETERMINATIONS OF EXEMPT STATUS OF NONPROFIT ORGANIZATIONS IN PARTNERSHIPS

Historically, the ability of an organization to receive and maintain exempt status hinged on whether the organization was organized and operated to further an exempt purpose under § 501(c)(3) of the Code. Of particular importance to housing developers is that § 501(c)(3) of the Code permits developing affordable housing to be a charitable purpose. As partnerships between exempt organizations and for-profit partners became more common, a series of IRS rulings and court decisions formed a two-part test to determine whether partnerships jeopardize an organization's exempt status. The IRS's application of this two-part test to various exempt organizations created an assortment of binding and non-binding authority for developers in LIHTC partnerships seeking to protect their exempt status. In addition, the courts have developed a separate "commerciality doctrine" that prohibits exempt organizations from competing with for-profit entities. Developers must satisfy both the two-part test and the commerciality doctrine to maintain exempt status.

A. The IRS Initially Established that the Development of Housing for Low-Income Persons Can Be a Charitable Purpose

Prior to 1968, the IRS provided little guidance as to whether housing developers were eligible for exempt status. During the late 1960s and 1970s two Revenue Rulings and a U.S. Tax Court decision offered guidance to determine whether providing housing to low-income persons

68. *See* 26 U.S.C. § 42(h)(6) (1994).
69. *Id.* § 42(h)(5)(B).
70. *Id.* § 42(h)(5)(C)(i).
71. 26 C.F.R. §1.501(c)(3)–(a)(1).

qualifies as a charitable purpose under the Code.[72] When providing examples of charitable purposes, the non-binding Revenue Rulings relied on the definition of "charitable" within the Regulations. The Tax Court also required organizations to satisfy the organizational and operational tests from the Regulations.[73]

In 1968, the IRS issued Revenue Ruling 68-17 and declared that housing developers for low-income persons may qualify as § 501(c)(3) organizations.[74] The IRS considered the exempt status of a nonprofit organization that instituted a housing program for low-income persons and provided information about the program to other organizations.[75] The organization acquired, rehabilitated, and sold or leased deteriorating residential buildings in distressed neighborhoods.[76] The Ruling indicated that the purpose and activities of the organization are charitable to the extent community deterioration is reduced by providing housing to low-income persons.[77]

Two years later, the IRS released Revenue Ruling 70-585,[78] providing more specific analysis of types of housing organizations qualifying for exempt status. Similar to Revenue Ruling 68-17, this Ruling relied on the definition of "charitable" in the Regulations. In particular, the IRS found numerous purposes exempt under § 501(c)(3) including (1) relieving the poor by providing housing to those who could otherwise not afford it, (2) eliminating prejudice and discrimination by developing mixed-income buildings, and (3) combating community deterioration by rehabilitating residential buildings.[79]

Several years later the Tax Court further clarified the activities related to housing development that are considered charitable under the Code. In *B.S.W. Group, Inc. v. Commissioner*,[80] the court applied the organizational[81] and operational[82] tests of the Regulations to revoke the tax-

72. B.S.W. Group, Inc. v. Comm'r, 70 T.C. 352 (1978); Rev. Rul. 70-585, 1970-2 C.B. 115; Rev. Rul. 68-17, 1968-1 C.B. 247.

73. *B.S.W. Group*, 70 T.C. at 356.

74. Rev. Rul. 68-17, 1968-1 C.B. 247.

75. *Id.*

76. *Id.*

77. *Id.*

78. Rev. Rul. 70-585, 1970-2 C.B. 115.

79. *Id.*

80. 70 T.C. 352 (1978).

81. *See supra* notes 58–63 and accompanying text.

82. *See supra* notes 64–67 and accompanying text.

exempt status of an organization providing consulting services for a fee to nonprofit organizations engaged in rural development.[83] Although B.S.W. Group met the organizational requirements of the Code, the Tax Court held that the organization failed the operational test by not operating exclusively for charitable purposes under § 501(c)(3) because its primary purpose was operating a commercial for-profit business.[84] Thus, to qualify as an exempt organization under § 501(c)(3), a low-income housing developer must satisfy the charitable-purpose requirement, the organizational test, and the operational test.

B. *Development of a Two-Prong Test To Determine Whether Organizations Partnering with For-Profit Investors Qualify for Exempt Status*

Even if an organization qualifies as an exempt § 501(c)(3) organization under the above tests, the organization might lose its exempt status if it partners with for-profit investors. The IRS initially took a firm position that partnerships between for-profit and nonprofit entities would result in the loss of tax-exempt status.[85] The Ninth Circuit rejected this position in *Plumstead Theatre Society, Inc. v. Commissioner*.[86] The IRS then released a memorandum containing a two-prong test to determine whether or not a charitable purpose is fostered by the partnership.[87]

In 1975, the IRS established a per se rule against joint ventures between for-profit investors and nonprofit organizations in General Counsel Memorandum 36,293.[88] This Memorandum addressed a partnership formed to provide housing to low- and middle-income households.[89] The IRS stated that a limited partnership with an exempt organization as general partner was "legally incompatible with operating exclusively" for a charitable purpose.[90] The IRS based this decision on three factors. First, the partnership allowed sharing of profits between

83. *B.S.W. Group*, 70 T.C. at 352.
84. *Id.* at 360.
85. Gen. Couns. Mem. 36,293 (May 30, 1975).
86. 675 F.2d 244 (9th Cir. 1982), *aff'g* 74 T.C. 1324 (1980).
87. Gen. Couns. Mem. 39,005 (June 28, 1983).
88. Gen. Couns. Mem. 36,293 (May 30, 1975).
89. *Id.*
90. *Id.*

private investors and charitable organizations.[91] Second, the nonprofit entity serving as general partner promoted the financial interests of the for-profit partners.[92] Finally, the equity of the private investors was protected while the charitable assets of the general partner were at risk.[93]

In 1982, the Ninth Circuit in *Plumstead Theatre Society, Inc. v. Commissioner*[94] affirmed the Tax Court's decision to reject the per se rule that exempt organizations lose their § 501(c)(3) status when they partner with for-profit investors.[95] Plumstead Theatre, a § 501(c)(3) organization that promoted the performing arts,[96] formed a limited partnership with several investors and took on the role of the general partner to produce a single play.[97] The limited partners provided the necessary capital in exchange for a 63.5% share in the profits from the production.[98] The Ninth Circuit upheld the Tax Court's decision that the exempt status of the theatre was not jeopardized by the partnership.[99] The Tax Court's decision was based on four factors. First, the transaction was at arm's length and for a reasonable price.[100] Second, the organization was not obligated to return the limited partner's capital.[101] Third, the partnership had no interest in any other plays,[102] eliminating the possibility of a profit motive.[103] Finally, the limited partners had no control over the operation or management of the partnership.[104]

The following year, the IRS released General Counsel Memorandum 39,005, which articulated a two-part test for determining whether the formation of a partnership between for-profit investors and an exempt organization requires revoking an organization's tax-exempt status.[105]

91. *Id.*

92. *Id.*

93. *Id.*

94. 675 F.2d 244, 245 (9th Cir. 1982), *aff'g* 74 T.C. 1324 (1980).

95. *Id.*; *see also* Rochelle Korman & Dahlia Balsam, *Joint Ventures with For-Profits After Revenue Ruling 98-15*, 27 EXEMPT ORG. TAX REV. 441, 442 (2000); Michael Sanders & Susan A. Cobb, *Recent IRS Rulings Provide New Standards for Joint Ventures Involving Charities*, 18 EXEMPT ORG. TAX REV. 213 (1997).

96. *Plumstead*, 675 F.2d at 244.

97. *Id.* at 245.

98. *Plumstead*, 74 T.C. at 1328.

99. *Plumstead*, 675 F.2d at 245.

100. *Plumstead*, 74 T.C. at 1333.

101. *Id.* at 1333–34.

102. *Id.* at 1334.

103. Korman & Balsam, *supra* note 95, at 442; Sanders & Cobb, *supra* note 95, at 214.

104. *Plumstead*, 74 T.C. at 1334.

105. Gen. Couns. Mem. 39,005 (June 28, 1983).

Memorandum 39,005 responded to a request for a ruling on the § 501(c)(3) status of a nonprofit general partner in a limited partnership formed to construct and to operate housing for the elderly and handicapped.[106] The IRS determined that the organization's exempt status was not jeopardized because under the partnership agreement the organization acted exclusively to further its exempt purpose.[107] The IRS set out a two-pronged "strict scrutiny" test.[108] Under this test, a partnership must (1) further a tax-exempt purpose and (2) be structured to ensure that the exempt organization will act exclusively to further exempt purposes without benefiting the nonexempt partners.[109]

C. *Recent Application and Refinement of the Two-Prong Test*

Although not always referring to the two-prong test, the IRS has continued to refine the several factors within the test to determine whether an organization will lose its exempt status by participating in an LIHTC partnership. The first prong, testing whether the partnership furthers an exempt purpose (the charitable-purpose prong), was clarified by a 1996 Revenue Procedure with guidelines for developers seeking exempt status for developing housing.[110] The second prong, (the private-benefit prong) requires that (1) the nonprofit entity control the partnership to enable it to further its charitable purpose, (2) the partnership does not obligate the nonprofit to place its charitable assets at risk, and (3) the partnership does not create a private benefit for the for-profit investors.[111] The private-benefit prong is generally the crucial part of the test and has been applied in several cases,[112] General Counsel Memorandums,[113] and Private Letter Rulings.[114]

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106. *Id.*

107. *Id.*

108. *Id.*

109. *Id.*

110. Rev. Proc. 96-32, 1996-1 C.B. 717.

111. *Id.*

112. *See, e.g.*, Hous. Pioneers, Inc. v. Comm'r, 58 F.3d 401 (9th Cir. 1995), *aff'g* T.C. Memo 1993-120 (1993); Am. Campaign Acad. v. Comm'r, 92 T.C. 1053 (1989).

113. *E.g.*, Gen. Couns. Mem. 39,444 (July 18,1985).

114. *See* Priv. Ltr. Rul. 97-36-039 (June 9, 1997); Priv. Ltr. Rul. 97-31-038 (May 7, 1997); Priv. Ltr. Rul. 96-16-005 (Dec. 19, 1995).

1. Housing Developers Can Satisfy the Charitable-Purpose Prong in Two Ways

Revenue Procedure 96-32 defines a safe harbor for organizations to satisfy the charitable-purpose prong by providing relief to the poor through developing housing for low-income persons.[115] The Procedure also describes the conditions necessary for an organization not falling within the safe harbor to secure exempt status under the Code.[116] Both situations in the Procedure focus on whether the housing development qualifies as charitable by providing relief to the poor and distressed.[117]

To fall within the safe harbor, the organization must reserve at least seventy-five percent of the apartments in each project for low-income tenants.[118] In addition, low-income persons must actually occupy the units.[119] The organization may rent the remaining units to families that do not qualify as low-income.[120] The IRS determined that this mix of income levels "assist[s] in the social and economic integration" necessary to aid in the purpose of relieving "the poor and distressed."[121]

To determine whether an organization that does not meet the safe-harbor guidelines can obtain charitable status, the IRS examines whether the organization relieves the poor and distressed.[122] In making this determination, the IRS examines all of the facts and circumstances surrounding the project.[123] Factors considered include the percentage of residents with certain income levels, the affordability of the units, the level of community-based board membership, the provision of additional social services, an affiliation with a § 501(c)(3) organization, and the existence of affordability covenants or restrictions.[124] Therefore,

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115. Rev. Proc. 96-32, 1996-1 C.B. 717. The safe harbor simplified the process of determining whether housing is a charitable purpose by focusing on relief to the poor and distressed. *See id.*

116. *Id.*

117. *See id.*

118. *Id.*

119. *Id.*

120. *Id.*

121. *Id.* In addition to relief of the poor and distressed, housing developers that meet any of the charitable purposes listed in § 501(c)(3) may be exempt. *Id.* The purposes within the Revenue Procedure include, but are not limited to, (1) "[c]ombating community deterioration," (2) "[l]essening the burdens of government," (3) "[e]limination of discrimination and prejudice," (4) "[l]essening neighborhood tensions," and (5) "[r]elief of the elderly or physically handicapped." *Id.*

122. *Id.*

123. *Id.*

124. *Id.*

organizations that do not satisfy the safe harbor must demonstrate a commitment to providing affordable housing to low-income persons.

2. *Housing Developers Must Meet Three Overlapping Conditions To Satisfy the Private-Benefit Prong*

In addition to satisfying the charitable-purpose prong, nonprofit organizations seeking to maintain their exempt status must satisfy the second prong: furthering a charitable purpose without conferring a private benefit. The three factors involved in the private-benefit prong are the organization's control over partnership activities, risk to the organization's assets, and private benefit to the for-profit investors. A chronological analysis of the application of the second prong reveals the degree to which the factors are intertwined.

a. *Early Applications of the Private-Benefit Prong Focused on Incidental Benefits*

During the period after *Plumstead*, the IRS and Tax Court focused on whether an organization's activities created an impermissible private benefit or merely an incidental benefit. In 1985, the IRS issued General Counsel Memorandum 39,444 in response to a request for a determination of the exempt status of an organization entering into a partnership created to purchase and lease an office building.[125] The memorandum stated that certain incidental private benefits would not jeopardize an exempt organization's status if these benefits did not affect the organization's ability to further its exempt purpose.[126] The IRS determined that the threshold question is whether the partnership furthers an exempt purpose.[127] In making this decision, the IRS first evaluated whether the organization's exempt purpose was furthered by the partnership's activities.[128] The IRS then analyzed whether the partnership agreement satisfied the control factor of the private-benefit prong by requiring the exempt organization to "act exclusively in furtherance of its exempt goals."[129] In determining this question, the IRS focused on the

125. Gen. Couns. Mem. 39,444 (July 18, 1985).

126. *See id.*

127. *See id.*

128. *Id.*

129. *Id.*

private-benefit factor of the prong, requiring that benefits received by for-profit partners be incidental[130] to the public purposes.[131]

In particular, Memorandum 39,444 considered the composition of the partnership's board. The IRS feared that the nonprofit general partner would be swayed by the limited partners and that the charitable purpose of the organization would not be protected.[132] To combat this vulnerability, the IRS recommended establishing an independent committee to monitor the board.[133] The committee would decrease the control of the limited partners, who would no longer have a strong presence on the board.[134] The IRS found that minimizing the control of the limited partners would eliminate the potential for the limited partners to create private benefits.[135] If the limited partners are not creating benefits, the benefits are more likely to be viewed as incidental.

Four years after Memorandum 39,444, the Tax Court, in *American Campaign Academy v. Commissioner*,[136] provided further guidance in the application of the private-benefit prong. American Campaign Academy was organized to train students for positions in political campaigns.[137] The IRS discovered that the academy's graduates all obtained positions with Republican candidates and organizations.[138] Consequently, it determined that the school benefited the private interest of the Republican Party.[139] The Tax Court stated that qualifying for exempt status does not depend solely on an organization's purpose or its original statement of purpose.[140] Rather, the IRS "look[s] beyond the four corners of the organization's charter to discover 'the actual objects motivating the organization and the subsequent conduct of the organization.'"[141]

130. Any private benefit must be both qualitatively and quantitatively "incidental" to the overall public benefit of the activity if the organization is to remain exempt. *See* Gen. Couns. Mem. 39,862 (Nov. 21, 1991). To be qualitatively incidental, the public benefit must be one that could not be achieved without benefiting private individuals. *Id.* To be quantitatively incidental, a benefit must be insubstantial in relation to the public benefit. *Id.*

131. Gen. Couns. Mem. 39,444 (July 18, 1985).

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. 92 T.C. 1053 (1989).

137. *Id.* at 1053.

138. *Id.*

139. *Id.* at 1053–54.

140. *Id.* at 1064.

141. *Id.* (quoting Taxation With Representation v. United States, 585 F.2d 1219, 1222 (4th Cir. 1978)).

The court analyzed the private-benefit factor by determining if any of the net earnings were distributed to the benefit of private shareholders or individuals. First, the Tax Court held that if more than an insubstantial part of an organization's activities do not further an exempt purpose, the organization will fail the operational test under § 501(c)(3).[142] In addition, if the organization benefits designated individuals, founders, shareholders, or family members, the organization does not operate exclusively for exempt purposes.[143] On the other hand, infrequent economic benefits that are incidental to the organization's charitable purpose are acceptable private benefits.[144] This decision is relevant to LIHTC partnerships because it provides further evidence of the IRS's position that incidental benefits arising out of partnerships will not jeopardize the exempt status of a nonprofit general partner.

b. Housing Pioneers*: The LIHTC Partnership that Failed the Private-Benefit Prong*

In *Housing Pioneers v. Commissioner*,[145] the Ninth Circuit restricted the ability of organizations to maintain their exempt status while participating in LIHTC partnerships with for-profit investors. The court held that Housing Pioneers, a nonprofit organization created to provide innovative, affordable housing and participating in an LIHTC partnership, did not qualify for exempt status.[146] In 1989, it partnered with several for-profit limited partners to develop housing that could be rented at reduced rates due to the entity's exempt status.[147] The Tax Court held that Housing Pioneers did not qualify for exemption because it had a non-exempt purpose that was "substantial in nature"[148] and because private investors benefited from the partnership.[149]

On appeal to the Ninth Circuit, Housing Pioneers argued that as a matter of law the LIHTC limits the requirements of § 501(c)(3) because

142. *See* at 1065.

143. *Id.* (noting that when organization's net earnings benefit private shareholder or individual, it creates non-exempt private purpose).

144. *See id.* at 1066.

145. 58 F.3d 401 (9th Cir. 1995).

146. *Id.*

147. *Id.* at 402.

148. *Id.* ("This non-exempt purpose was to provide the benefit of both the California § 214 exemption and the federal § 42 credit to partnerships that were not exclusively charitable.").

149. *Id.*

it provides tax credits to for-profit companies and automatically creates a private benefit for investors.[150] The Ninth Circuit did not rule on this issue.[151] Instead, the court held that the nonprofit failed to "materially participate" in the development and operation of the project through activities that were "regular, continuous, and substantial" and therefore did not qualify as a qualified nonprofit organization within the LIHTC.[152] Because Housing Pioneers did not qualify as a nonprofit under the LIHTC, the court focused solely on Housing Pioneers' qualification for § 501(c)(3) status.[153] The court upheld the Tax Court's decision that disqualified Housing Pioneers as a § 501(c)(3) organization because its activities included a substantial non-exempt purpose: private investors realized a benefit from the ability to reduce rents because of the tax exemption without having to depend on the partnership's assets to cover expenses.[154] Although the court did not specifically refer to the strict-scrutiny test, this holding provides an additional example of the types of private benefits that jeopardize exempt status.

c. *The IRS Has Found Guarantees To Be Impermissible Under the Private-Benefit Prong*

Throughout the 1990s, the IRS examined guarantees by exempt organizations that placed charitable assets at risk to protect the assets of investors. The low value of an exempt organization's assets—generally unimproved land or dilapidated housing—often causes investors to seek indemnities and guarantees to protect their investment.[155] Investors in housing for low-income persons want sufficient security before committing capital to the project.[156] They have the money and often dictate and draft the terms of the partnership.[157] Frequently, investors offer their investment on a take-it-or-leave-it basis.[158] Ultimately,

150. *See id.* at 403.
151. *Id.* at 404.
152. *Id.* at 403–04.
153. *Id.* at 404.
154. *Id.* at 402–03.
155. Klein & Rubin, *supra* note 2, at 92; *see also* SANDERS, *supra* note 7, § 12.2(c)(iii), at 421.
156. Lee A. Sheppard, *A Bad Mix: Do-Gooders and Tax Shelters*, 19 EXEMPT ORG. TAX REV. 23, 29 (1998).
157. Kawecki & Friedlander, *supra* note 4, Part II(2)(B).
158. *Id.*

agreements that obligate exempt organizations to place charitable assets at risk are impermissible because they benefit for-profit investors.

The IRS analysis of impermissible guarantees in a Memorandum and three Private Letter Rulings provide non-binding examples of the IRS's application of the private-benefit prong to exempt organizations that partner with for-profit investors. The rulings detail several types of guarantees and indemnifications and whether they place the exempt status of organizations at risk.[159] One of the rulings also articulates a new standard for the third factor of the private-benefit prong: that partnerships must not "overly benefit" private, for-profit investors.[160]

In 1991, the IRS issued a General Counsel Memorandum that illustrates the Service's disapproval of loss reserves[161] from a nonprofit's assets. In responding to an inquiry from an exempt hospital wishing to form a joint venture, the IRS determined that the venture created a private benefit that was "too great . . . to be considered incidental to the charitable purposes."[162] One reason cited was that the partnership agreement required the hospital to establish loss reserves financed with hospital funds.[163] The IRS viewed the loss reserve as a risk to the exempt hospital's charitable assets that jeopardized its exempt status[164] under the second factor of the private-benefit prong.

In 1997, the IRS issued Private Letter Ruling 97-31-038 concerning the participation of a § 501(c)(3) organization in a partnership to provide mixed-income housing.[165] The ruling illustrates that when nonprofit general partners give environmental indemnifications, credit-adjustment guarantees, or return-of-capital guarantees to for-profit limited partners, the nonprofit organization jeopardizes its exempt status.

The nonprofit general partner seeking the Private Letter Ruling provided environmental indemnifications to investors. Under an initial environmental indemnification, the nonprofit assumed all liability for

159. *See* Gen. Couns. Mem. 39,862 (Nov. 21, 1991); Priv. Ltr. Rul. 97-36-039 (June 9, 1997); Priv. Ltr. Rul. 97-31-038 (May 7, 1997); Priv. Ltr. Rul. 96-16-005 (Dec. 19, 1995).

160. Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

161. A loss reserve is an account providing money to the partnership if it does not have enough revenue to cover costs. Kawecki & Friedlander, *supra* note 4, Part II(5)(A). Loss reserves are established in advance of any losses and can be from partnership assets or the general partner's assets. Gen. Couns. Mem. 39,862.

162. Gen. Couns. Mem. 39,862.

163. *Id.*

164. *See id.*

165. *See* Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

any future environmental costs.[166] The partnership later amended the indemnification to limit liability to gross negligence or willful misconduct by the general partner.[167] Furthermore, environmental assessments had previously been made on each of the partnership's projects.[168] The IRS ruled that under the amended indemnification the organization's exempt status was not at risk.[169]

The nonprofit general partner also included credit-adjustment guarantees in the partnership agreement. The partnership amended the provisions so that the exempt organization was not required to cover any credit reductions.[170] Credit-adjustment guarantees are commonly used to assure investors that if the project fails to qualify for any or all of the estimated LIHTC, the projected returns to the investor will still be realized.[171] The amended agreement provided that additional payments by the exempt organization would be regarded as a capital contribution.[172] As a result, the IRS found that the organization's exempt status was not at risk because the increased capital contribution would be used to carry out the charitable purpose and would be returned to the organization upon dissolution.[173]

Finally, the exempt general partner provided a guarantee to return the investors' capital if the project was not completed on time.[174] The IRS focused on the fact that three of the projects were already in operation and remaining completion dates were within the organization's control because it served as the developer of the project.[175] Consequently, the IRS determined that the guarantee did not "overly benefit" investors and did not place the exempt status of the general partner at risk.[176]

Of primary importance was the IRS's use of "overly benefit" as a standard for prohibited private benefits.[177] Prior to this ruling, the IRS

166. *Id.*

167. *Id.*

168. *Id.*

169. *See id.*

170. *See id.* Tax credits are allocated based on estimated expenses that may change as the project proceeds. *See* SANDERS, *supra* note 7, § 12.2(h), at 433.

171. *See* SANDERS, *supra* note 7, § 17.6(b)(ii), at 565; Michael Sanders, *Hot Issues Affecting Partnerships and Joint Ventures Involving Nonprofits*, 20 EXEMPT ORG. TAX REV. 93, 100 (1998).

172. Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

173. *Id.*

174. *Id.*

175. *Id.*

176. *Id.*

177. *See id.*

had used a standard of whether the private benefit to limited partners was quantitatively and qualitatively incidental to public benefits from the partnership.[178] The "overly benefit" standard signified a relaxation of the incidental benefit standard.

In another non-binding ruling, Private Letter Ruling 97-36-039, the IRS specifically addressed the participation of an exempt organization acting as general partner in a limited partnership using the LIHTC. The exempt organization had a 0.15% general-partner interest and a for-profit corporation held a 0.85% general-partner interest.[179] Another for-profit investor owned the remaining ninety-nine percent interest.[180]

The original partnership agreement was problematic because it obligated the general partners to return capital to the for-profit investors upon an allocation differential in the projected credits, a credit shortfall, or a credit recapture.[181] The partnership also approved a pledge and security agreement, in which only the nonprofit agreed to pledge its entire interest upon default.[182] Therefore, the exempt general partner was obligated to surrender its partnership interest if the two general partners could not return the capital of the for-profit investors if there was a reduction in the amount of LIHTC received by the partnership. The parties eventually terminated the pledge and security agreement, which benefited the investors and the for-profit general partner, because it would be exercised if the for-profit general partner did not satisfy its guarantees to return capital to the investors.[183] Consequently the IRS ruled in favor of maintaining the exempt status of the organization because the nonprofit did not place its assets at risk and did not cause an impermissible private benefit.[184] This decision offers further evidence that the IRS will deny exempt status to nonprofit general partners who provide standard guarantees such as loss reserves, environmental indemnifications, credit-adjustment guarantees, or return-of-capital guarantees to for-profit limited partners on the basis that the agreements confer an impermissible private benefit.

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178. Sanders & Cobb, *supra* note 95, at 216. Although no other rulings use this standard, the IRS referred to the "overly benefit" standard in 1995 continuing professional education materials for exempt organizations. Kawecki & Friedlander, *supra* note 4, Part II(2)(B).

179. Priv. Ltr. Rul. 97-36-039 (June 9, 1997).

180. *Id.*

181. *Id.*

182. *Id.*

183. *Id.*

184. *See id.*

d. The Private-Benefit Prong Is Met when the Exempt Partner Maintains Control over the Joint Venture Such that It Furthers the Organization's Exempt Purpose

In 1998, the IRS issued Revenue Ruling 98-15,[185] which determined the extent of control by the tax-exempt partner over the partnership's activities needed to satisfy the control factor of the private-benefit prong. The ruling focused on whether a nonprofit hospital participating in a joint venture with a for-profit entity continued to qualify for an exemption under § 501(c)(3) of the Code.[186] The IRS ruled that an organization may participate in a partnership without jeopardizing its exempt status if "participation in the partnership furthers a charitable purpose, and the partnership arrangement permits the exempt organization to act exclusively in furtherance of exempt purposes and only incidentally for the benefit of the for-profit partners."[187]

The ruling detailed two fact patterns. In the first situation, the articles of organization stated that the governing board would consist of three members appointed by the exempt organization and two by the for-profit partners.[188] The document also called for a majority vote (at least three members) to approve "certain major decisions."[189] Furthermore, the governing documents required that the partnership be operated to further charitable purposes and stipulated that this purpose would override any duty to operate for financial benefit.[190] The second situation differed because it called for six board members, equally split between the exempt organization and the for-profit partners.[191] It also required a majority vote on major decisions, although the list of decisions was shorter than in the first situation.[192] Finally, there was no statement of putting the charitable purpose before the financial interests of the partners.[193]

Applying the two-part test, the IRS stated that the control requirement of the private-benefit prong is met when the exempt partner maintains

185. Rev. Rul. 98-15, 998-12 I.R.B. 6.

186. *Id.*

187. *Id.* at 9.

188. *Id.* at 6.

189. *Id.*

190. *Id.*

191. *Id.* at 6–7.

192. *Id.*

193. *Id.* at 7.

sufficient control over the partnership's activities to demonstrate that the partnership furthers exempt purposes.[194] The IRS limited the determination of satisfying the control factor to whether the organization maintains voting control. The ruling dictated that a fifty-fifty split in the board membership agreement would not allow the exempt organization to make decisions without securing a vote from a member of the for-profit partner.[195] The IRS determined that the inability to control the partnership by initiating programs without a vote from the for-profit member limited the exempt hospital's power to operate "exclusively for exempt purposes."[196] Thus, a nonprofit must maintain fifty-one percent voting control to satisfy the control requirement and retain exempt status.[197]

Nonprofit developers in LIHTC partnerships must satisfy the two-prong strict-scrutiny test to maintain exempt status. The IRS issued a safe harbor for developers of housing for low-income persons to satisfy the charitable-purpose prong. The private-benefit prong, on the other hand, consists of three overlapping factors: the ability to maintain control, the risk to charitable assets, and the degree of private benefit. These factors have been the source of numerous General Counsel Memorandums, Private Letter Rulings, and Revenue Rulings.[198]

D. *The Commerciality Doctrine Prohibits Exempt Organizations from Participating in Activities Considered Commercial*

Apart from IRS rulings, the courts have developed a separate body of law, the commerciality doctrine,[199] which has become important in determining an organization's exempt status. The commerciality doctrine reflects the belief that it is unfair for exempt organizations to compete with organizations in the for-profit sector.[200] Under the doctrine, a tax-

194. *Id.* at 8.

195. *Id.* at 9.

196. *Id.*

197. *See id.* at 9.

198. *See id.*; Gen. Couns. Mem. 39,862 (Nov. 21, 1991); Gen. Couns. Mem. 39,444 (July 18, 1985); Gen. Couns. Mem. 39,005 (June 28, 1983); Priv. Ltr. Rul. 97-36-039 (Sept. 5, 1997); Priv. Ltr. Rul. 97-31-039 (May 7, 1997); Priv. Ltr. Rul. 96-16-005 (Dec. 19, 1995).

199. Better Bus. Bureau of Wash. D.C., Inc. v. United States, 326 U.S. 279 (1945); Living Faith, Inc. v. Comm'r, 950 F.2d 365 (7th Cir. 1991), *aff'g* 60 T.C.M (CCH) 710 (1990).

200. BRUCE R. HOPKINS, THE LAW OF TAX-EXEMPT ORGANIZATIONS 630 (7th ed. 1998).

exempt organization is engaged in a non-exempt activity when that activity is undertaken in a commercial manner.[201]

The first articulation of the commerciality doctrine came in *Better Business Bureau v. United States*.[202] The U.S. Supreme Court held that the organization had a "commercial hue" and that its "activities [were] largely animated by this commercial purpose."[203] The clearest explanation of the doctrine is found in *Living Faith, Inc. v. Commissioner*.[204] The Seventh Circuit identified factors indicative of commercial activities: (1) selling goods and services to the public, (2) direct competition with a for-profit, (3) prices common in retail, (4) advertising, (5) promotional materials, (6) hours of operation similar to for-profit, (7) salaried employees rather than volunteers, and (8) lack of charitable contributions.[205] In both cases the courts affirmed the denial of exempt status based on the commercial aspects of each organization's activities.[206]

III. ONLY PIECEMEAL GUIDANCE IS AVAILABLE TO DEVELOPERS WISHING TO MAINTAIN EXEMPT STATUS AND PARTICIPATE IN LIHTC PARTNERSHIPS

Although the IRS and federal courts have provided guidance to various organizations seeking to maintain exempt status, the lack of comprehensive authority provides only piecemeal guidance for exempt developers wishing to partner with for-profit investors in LIHTC partnerships. The clearest requirement is that all exempt organizations must be organized and operated to further a charitable purpose under § 501(c)(3) of the Code.[207] In addition, the Treasury regulations guide organizations seeking to obtain or maintain exempt status by providing both a detailed definition of charitable and tests to satisfy the organizational and operational requirement.[208] Beyond these

201. *Id.* at 629. An act is commercial "if it has a direct counterpart in, or is conducted in the same manner," as an act of a for-profit organization. *Id.* at 629–30.

202. 326 U.S. 279 (1945).

203. *Id.* at 283–84.

204. 950 F.2d 365 (7th Cir. 1991).

205. *Id.* at 372–75; *see also* HOPKINS, *supra* note 200, at 640.

206. *See Better Business*, 326 U.S. at 286; *Living Faith*, 950 F.2d at 376–77.

207. *See* 26 U.S.C. § 501(c)(3) (1994).

208. *See* 26 C.F.R. § 1.501(c)(3) (2000).

requirements, there is only confusion for the developer hoping to partner with a for-profit investor.

The inconsistency of the IRS and the courts in the method used to determine whether an organization's exempt status has been jeopardized creates a confusing environment for exempt organizations seeking to protect their status while participating in LIHTC partnerships. Furthermore, many of the decisions do not focus on the particularities of the housing industry. Private Letter Ruling 97-31-038 provides the most complete analysis of the types of guarantees that the IRS will view to be impermissible private benefits.[209] Yet, the ruling is of limited value because the risk to the general partner's exempt status was minimized due to the completion of three of the five projects prior to the ruling.[210] This ruling also introduced the standard of "overly benefit," a more relaxed standard than the incidental-benefit standard used previously.[211] It is unclear which standard currently applies and LIHTC partnerships have no guidance as to which one to follow. The result of the numerous tests and various factors relied upon by the IRS and courts in determining exempt status is a lack of comprehensive authority on protecting exempt status for nonprofit developers in LIHTC partnerships.

IV. THE IRS SHOULD ISSUE A REVENUE PROCEDURE TO GUIDE EXEMPT DEVELOPERS APPLYING THE PRIVATE-BENEFIT PRONG TO LIHTC PARTNERSHIPS

To protect the exempt status of developers in LIHTC partnerships, the IRS should issue a Revenue Procedure to provide binding authority for satisfying the private-benefit prong. Without such guidance, developers will be at risk of losing their exempt status, and there will be fewer exempt organizations willing to participate in LIHTC partnerships. First, the IRS should adopt the position that exempt organizations satisfy the requirement of furthering the charitable purpose through control of day-to-day management activities. Second, the charitable-assets test, which prohibits placing charitable assets at risk by providing guarantees to investors, should allow for an exception for guarantees that are standard in the development industry. Finally, the IRS should formally adopt the "overly benefit" rather than the "incidental benefit" measurement to

209. *See* Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

210. *See id.*

211. *See id.*

determine impermissible private benefits. Unless the IRS provides more guidance to protect the exempt status of housing developers, the success of the LIHTC program will be jeopardized.

A. *The IRS Should Require Exempt Organizations To Maintain Control of Day-to-Day Management and Not Majority Voting Control on the LIHTC Partnership's Board*

Exempt organizations should be able to satisfy the control requirement of the private-benefit prong of the strict-scrutiny test[212] if they retain control of the day-to-day management activities of the partnership rather than establish voting control of the board. The most recent IRS ruling on the exempt status of an organization in a partnership, Revenue Ruling 98-15, indicates that the IRS will not revoke the exempt status of an organization that maintains fifty-one percent voting control of the partnership board and is controlled by a provision in the partnership agreement obligating the partnership to further charitable purposes.[213] On the other hand, the IRS finds that an organization without majority voting control and no statement of charitable purposes has jeopardized its exempt status.[214] Revenue Ruling 98-15 should not apply to LIHTC partnerships because it confuses rather than clarifies the issue of control required by the private-benefit prong of the test.[215] Securing voting control for certain major decisions, as required by the ruling,[216] does not automatically increase an organization's ability to further the exempt purpose through the partnership. Rather than applying the ruling to LIHTC partnerships, the IRS should provide binding authority granting exempt organizations the greatest opportunity for promoting charitable purposes without jeopardizing their exempt status.

The first reason the Ruling should not apply to LIHTC partnerships is that it does not consider the quality of the board membership when dictating a fifty-one percent control requirement. For example, if a board member appointed by the investor, but not by the developer, is an expert in housing for low-income persons and is not motivated by profit, the lack of voting control by the nonprofit should not be a critical issue. If

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212. *See supra* note 111 and accompanying text.

213. *See* Rev. Rul. 98-15, 1998-12 I.R.B. 6.

214. *See id.*

215. *See supra* Part II.C.2.d.

216. *See* Rev. Rul. 98-15.

the expert is actually voting to promote housing for low-income persons, the developer's charitable purpose, then the exempt status of the developer should not be questioned. In General Counsel Memorandum 39,444, the IRS pointed to an independent committee as a favorable factor for exempt status because it would eliminate the degree of control of, and the potential for abuse by, the limited partners.[217] Moreover, an internal IRS manual directs agents to look favorably upon the appointment of an independent board of directors, especially if the individuals are involved in low-income housing.[218] Therefore, rather than focusing on the majority voting control requirement, the IRS should adopt the position that the appointment of an independent committee comprised of experts in low-income housing will be a favorable factor in protecting exempt status.

The second problem with Ruling 98-15 is that it does not specify the characteristics of major matters subject to the fifty-one percent control requirement. Although the ruling lists seven topics of major decisions, the ruling does not specify how to determine whether a decision is major and subject to the fifty-one percent requirement.[219] A fifty-one percent control requirement is logical only if it applies either to all decisions or only to those decisions affecting the charitable purpose of providing housing to low-income persons. The requirement should not apply to resolutions, such as changing the name of the partnership, that would not have any effect on the provision of housing for low-income persons.

The third question arising from the application of Ruling 98-15 to LIHTC partnerships is whether less than fifty-one percent voting power would be acceptable to the IRS if the board members are bound by a statement that charitable purposes take precedent over profit motives.[220] The fact pattern approved by the IRS contained such a statement and the scenario rejected by the IRS did not.[221] However, the inclusion of a charitable-purpose statement should protect the exempt status of the developer whether or not it has voting control only if the investors prove that they are acting in accordance with the statement and that the partnership is furthering the charitable purpose of the exempt organization. The Tax Court has stated that it is the conduct of the

217. Gen. Couns. Mem. 39,444 (July 18, 1985).

218. Kawecki & Friedlander, *supra* note 4, Part I(6).

219. *See* Rev. Rul. 98-15, 1998-12 I.R.B. 6.

220. *See id.*

221. *Id.*; *supra* notes 190 and 193 and accompanying text.

organization, not specific statements in the articles, that determine exempt status.[222] IRS officials have also acknowledged that day-to-day management is more important than anything written in the governing documents.[223] Therefore, although a statement of commitment to charitable purposes is favorable, a determination of the exempt status of an organization with less than majority voting control should be based primarily on whether the partnership is furthering the organization's charitable purpose.

The final shortcoming of Revenue Ruling 98-15 is that if voting control is a safe harbor for exempt status, there is no guarantee that charitable purposes are being furthered. The operational test for evaluating whether an exempt organization's status is at risk looks beyond the terms of agreements and examines whether the purpose is actually being furthered.[224] If the fifty-one percent control standard is a safe harbor, LIHTC partnerships may maintain their exempt status through securing voting control without "materially participating" in the daily activities of the partnership as required by *Housing Pioneers*.[225] The amount of control that satisfies the requirement of furthering an exempt purpose should be "material participation" through regular, continuous, and substantial activities as articulated in *Housing Pioneers*.[226]

The focus of an IRS determination of an organization's exempt status should be whether the organization "materially participates" in partnership activities and, more importantly, whether the partnership is furthering the charitable purposes of the exempt organization. The IRS should emphasize the importance of an independent committee and evidence that an organization's activities are furthering an exempt purpose. Similarly, the IRS should not base its decision on whether or not the exempt organization maintains voting control over the decisions of the Board of Directors of the partnership.

222. *See* Am. Campaign Acad. v. Comm'r, 92 T.C. 1053, 1064 (1989); *see also supra* notes 140–141 and accompanying text.

223. Barbara Yuill, *Tax Policy: Owens to Leave IRS for Private Sector; Updates Key Tax-Exempt and Health Care Issues*, 209 D.T.R. G-8 (Oct. 29,1999) ("Day-to-day management . . . is perhaps the most important factor and possibly even more significant than control of the board or written agreements between the parties.").

224. *See* 26 C.F.R. § 1.501(c)(3)–1(c) (2000); *see also supra* notes 140–141 and accompanying text.

225. Hous. Pioneers, Inc. v. Comm'r, 58 F.3d 401, 403 (9th Cir. 1995).

226. *Id.* at 403–04.

B. *In Determining Exempt Status, the IRS Should Allow an Exception to the Charitable-Assets Test for Standard Guarantees by Exempt Organizations to Investors*

When determining whether the partnership agreement obligates the nonprofit to place its charitable assets at risk, the IRS should exclude all guarantees between exempt organizations and for-profit investors that are standard within the housing industry. This component of the private-benefit prong has become increasingly important because guarantees and indemnifications are standard tools in providing security for investors in partnership agreements.[227] However, the IRS prohibits guarantees that insulate the limited partner's assets while increasing the risk to the charitable assets.[228] To allow for more equal footing between for-profit and exempt organizations competing for the LIHTC, the test should be amended to allow an exception for standard guarantees such as loss reserves, environmental indemnifications, credit adjustments, and return of capital.

1. *Loss Reserves Are a Necessary Component of LIHTC Partnerships and Should Not Jeopardize the Exempt Status of an Organization*

Loss reserves should not affect the exempt status of organizations in LIHTC partnerships because they are a common method for preparing for the possibility of lower-than-estimated profits.[229] Loss reserves are necessary in LIHTC projects due to the collection of lower rents from low-income persons. In General Counsel Memorandum 39,862, the IRS found that loss reserves established by the exempt organization place charitable assets at risk.[230] The IRS should not view such agreements as placing charitable assets at risk if the exempt organization is entitled to a priority return of capital upon disposition of the property.[231] Under such an agreement, when the partnership sells the property, the assets contributed by the exempt organization would be returned to the organization first, then the remaining assets would be divided according to the partnership interests.

227. *See supra* notes 155–158 and accompanying text.

228. *See* Gen. Couns. Mem. 39,862 (Nov. 21, 1991); Priv. Ltr. Rul. 97-36-039 (Sept. 5, 1997); Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

229. *See supra* note 163 and accompanying text.

230. *See supra* note 163 and accompanying text.

231. *See* SANDERS, *supra* note 7, § 17.6(c), at 567.

To accomplish the goals of loss reserves without jeopardizing exempt status, partnership agreements should establish reserves as specific capital contributions to the partnership rather than commitments to protect investors' assets.[232] If they are classified up-front as capital contributions to the partnership, the IRS will not view the reserves as set-asides from the exempt organization's assets to protect the investor's assets in the future. Alternatively, the source of the reserves could be the money earned by the exempt organization from developer's fees rather than directly from the organization's charitable assets.[233]

Whether the source of the reserve is developer's fees or the exempt organization's assets, the partnership agreement should provide that the exempt general partner is entitled to a priority return of capital upon disposition of the property.[234] By prioritizing the return of the capital to the organization, the risk to the charitable assets is minimized. The assets of the exempt general partner that are placed in the loss reserve will be returned to the organization before the remaining assets are divided among the partners. Because the charitable assets are used as a particular contribution and not as a way to protect the assets of the for-profit partners, the IRS should allow LIHTC partnerships to establish loss-reserves agreements without jeopardizing their exempt status.

2. *Environmental Indemnifications by an Exempt Organization for the Period of the Property's Use by a Partnership Should Not Jeopardize Its Exempt Status*

Environmental indemnifications for the period during which the property is used for low-income housing should not place the exempt status of an organization at risk because they are common tools in the development industry.[235] The IRS should adopt the view that exempt developers who obtain environmental assessments to assure that property is free of contamination and who have control of the project to prevent future environmental damage will not be placing their assets at risk. The IRS's disfavor of environmental indemnifications for "all losses [attributable] to the presence of hazardous materials at any time on or around the property, whether or not [the presence of the materials was] in

232. Sanders, *supra* note 171, at 101.

233. Sanders, *supra* note 171, at 101; *see also* SANDERS, *supra* note 7, § 17.6(c), at 567.

234. Sanders, *supra* note 171, at 101; *see also* SANDERS, *supra* note 7, § 17.6(c), at 567.

235. Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

[the would-be exempt organization's] control,"[236] creates an unfair competitive advantage in favor of for-profit recipients of the LIHTC who can freely give environmental indemnifications.

The IRS has determined that environmental indemnifications for the current condition of property will not jeopardize exempt status, but that indemnifications for future environmental conditions do place exempt status at risk.[237] The IRS has found that the warranty of the property by the exempt organization at the time of partnership formation is acceptable, especially after a Phase I environmental assessment is completed.[238] On the other hand, the IRS has found that warranties of future environmental conditions are impermissible because they protect the assets of the investors while placing the exempt developer's assets at risk.[239] Because exempt organizations control the activities of partnerships and indemnifications by the general partner are common, the IRS should not consider environmental indemnifications for the period of use for low-income housing in determining whether an organization's assets are at risk.

3. *Guaranteed Returns Despite Credit Adjustments Should Not Affect an Organization's Exempt Status Because Such Guarantees Are Common in LIHTC Partnerships*

Minimum investment returns are standard in LIHTC partnerships to assure investors a reasonable return upon a credit adjustment[240] and should not jeopardize an organization's exempt status. As the IRS stated in Private Letter Ruling 97-31-038, minimum investment returns could lead to an organization failing the private-benefit prong and the loss of exempt status.[241] Limited minimum investment returns should not jeopardize the exempt status of an organization because the LIHTC program, which encourages partnerships between nonprofit organizations and private investors, does not guarantee the amount of credits that a project will receive. If the exempt organization is prohibited from making such an agreement, investors will either turn to for-profit

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236. Sanders, *supra* note 171, at 101 (internal citation omitted).

237. *See* Priv. Ltr. Rul. 97-31-038.

238. *Id.*; *see also* SANDERS, *supra* note 7, § 17.6(c), at 567.

239. Sanders, *supra* note 171, at 101.

240. Priv. Ltr. Rul 97-31-038.

241. *See id.*; *see also supra* notes 170–172 and accompanying text; Sanders, *supra* note 171, at 100.

recipients of the LIHTC who can guarantee a return or only purchase the credits at a lower price. Both situations will reduce the amount of capital available to the nonprofit developers.

To be consistent with the LIHTC's preference for exempt developers,[242] the IRS should promote partnerships between exempt and for-profit partners by allowing such guarantees if capped at the accumulated developer fees.[243] If the guarantee is limited to the developer fees of the exempt organization, then the organization is only placing a limited amount of its charitable assets at risk. Furthermore, if the guarantee is treated as a capital contribution that will be returned to the charitable investor, the risk to the exempt organization's assets is minimal.[244] Thus, the IRS should not consider standard minimum-investment-return agreements when evaluating the private-benefit prong.

4. *Return-of-Capital Provisions Contingent on a Failure of an Exempt Organization To Satisfy a Partnership Agreement Should Not Jeopardize an Organization's Exempt Status*

Return-of-capital provisions are a common method of obligating partners to meet partnership agreements and should not place the exempt status of an organization in a LIHTC partnership at risk. Examples of provisions that may result in return of capital are completion guarantees[245] and guarantees of performance goals or activity levels.[246] The IRS's conclusion that these clauses impermissibly place charitable assets at risk if the provision obligates the developer to return capital out of its funds places an unfair burden on exempt organizations because for-profit developers are not subject to the same restrictions.[247] Outright prohibitions on these provisions for exempt organizations would make partnerships with nonprofit developers less attractive to LIHTC investors[248] and reduce the success of the LIHTC program. Standard provisions in partnership agreements such as loss reserves, environmental indemnifications, minimum investment returns, and

242. 26 U.S.C. § 42(h)(5)(A) (1994).

243. *See* SANDERS, *supra* note 7, § 17.6, at 565.

244. *See id.* at 568.

245. *See* Priv. Ltr. Rul. 97-31-038.

246. Sanders, *supra* note 171, at 100.

247. Sanders, *supra* note 171, at 100–01.

248. *See* Kawecki & Friedlander, *supra* note 4, Part II(2)(B).

return-of-capital agreements should not affect the IRS's determination of exempt status regarding charitable assets being at risk.

C. *The IRS Should Commit to the "Overly Benefit" Standard To Determine the Existence of Impermissible Private Benefit in LIHTC Partnerships*

The IRS should formally adopt the "overly benefit" standard for LIHTC partnerships because it allows exempt developers and for-profit investors to join in developing much needed affordable housing for low-income households. In 1982, the Ninth Circuit upheld the Tax Court's decision to abandon[249] the per se prohibition against private inurement that prohibited joint ventures between exempt and for-profit investors[250] for a new standard of incidental benefits.[251] Although a 1997 Private Letter Ruling dealing with an LIHTC partnership introduced the relaxed standard of "overly benefit,"[252] it is unclear whether the standard would apply to all LIHTC partnerships.[253] Despite not using the "overly benefit" standard in later rulings,[254] an IRS internal manual refers to this more relaxed standard.[255]

The IRS should adopt the "overly benefit" standard prior to the end of the compliance periods of first tax credit properties in 2001.[256] At that time, the partnerships will no longer need to maintain reduced rents, and the investors may wish to increase rents or sell the project. Although most LIHTC partnerships include provisions giving the right of first refusal to the "tax-exempt general partner or other tax-exempt entity,"[257] the effect of sale proceeds on exempt developers is uncertain. As long as the exempt developer purchases the property or reinvests the proceeds in a charitable purpose, the sale will not automatically terminate exempt

249. *See* Plumstead Theatre, Inc. v. Comm'r, 675 F.2d 244 (9th Cir. 1982), *aff'g* 74 T.C. 1324 (1980).

250. *See supra* notes 88–93 and accompanying text.

251. *See supra* Part II.C.2.c.

252. Priv. Ltr. Rul. 97-31-038 (May 7, 1997).

253. In this Private Letter Ruling, the IRS focused on the organization's ability to lessen the burdens on the government. SANDERS, *supra* note 7, § 4.2, at 143.

254. *See* Rev. Rul. 98-15, 1998-12 I.R.B. 6, 9.

255. *See* Kawecki & Friedlander, *supra* note 4, Part II(2)(B).

256. The LIHTC began in 1986. *See* SANDERS, *supra* note 7, § 12.2(a), at 416. The minimum compliance period is fifteen years. 26 U.S.C. § 42(i)(1) (1994).

257. SANDERS, *supra* note 7, § 12.2(l), at 438.

status.[258] However, the proceeds from a sale realized by investors may be an impermissible private benefit. In order for the exempt organization to maintain its charitable purpose, the housing must be sold for a minimum price as detailed in the Code.[259] Generally, the property is also subject to an additional fifteen-year compliance period that brings down the fair market value.[260] If the fair market value is high enough that the investors recognize a considerable return, the exempt status of the developer may be jeopardized.[261] The "overly benefit" standard would provide added security to developers seeking to protect their exempt status at the end of the compliance period.

This standard should apply to LIHTC partnerships because it will encourage partnerships between exempt developers and for-profit investors. The IRS should balance the public benefit from the LIHTC program and the societal benefits associated with an increased supply of affordable housing for low-income households against the private benefits of certain market-driven operation benefits.[262] The "overly benefit" standard should be established through a binding Revenue Procedure to provide clear guidance to nonprofit developers and ensure that LIHTC partnerships will continue after the first fifteen-year compliance period.

IV. CONCLUSION

The Low-Income Housing Tax Credit is the primary source of funding for the development of housing for low-income persons. Despite the program's role in funding such housing, exempt organizations awarded credits and entering into LIHTC partnerships do not have clear guidance for protecting their exempt status. Although the IRS has developed and applied a two-part test to determine whether an organization qualifies for exempt status, much of the authority is focused on the more general § 501(c)(3) requirements, non-binding, or not specific to housing organizations. Furthermore, the nature of the LIHTC program and partnership agreements in the development industry require board voting provisions and guarantees by the exempt organization that may put a

258. 26 C.F.R. § 1.501 (c)(3)-1(b)(4) (2000).

259. 26 U.S.C. § 42(i)(7).

260. SANDERS, *supra* note 7, § 12.2(1), at 438–39.

261. *See supra* notes 143–144 and accompanying text.

262. SANDERS, *supra* note 7, § 17.6(c), at 571.

nonprofit developer's exempt status at risk. Losing this status would result in the partnership's loss of the LIHTC and eventually a reduction in the amount of housing for low-income households.

To maintain the involvement of exempt organizations in LIHTC projects, the IRS should issue guidance through a Revenue Procedure. The Revenue Procedure would provide much needed binding authority to exempt organizations that will enable them to continue to partner with for-profit investors. The IRS's position would not violate the commerciality doctrine because nonprofits would not directly compete with for-profits. In particular, the IRS should specify that exempt organizations in LIHTC partnerships need only to maintain control of daily management activities, may provide guarantees that are common within LIHTC partnerships and the development industry, and may allow for financial rewards that do not "overly benefit" the for-profit investors. If the IRS adopts such standards, the risk to the exempt status of developers in LIHTC partnerships will be minimized and the supply of housing available to low-income households will continue to increase.