



Tax- Exempt Status for Organizations Participating in Low Income Housing Tax Credit Limited Partnerships

Introduction

On July 30, 2007, the IRS issued a Memorandum entitled “Low Income Housing Tax Credit Limited Partnerships,” which established new standards for determining the tax-exempt status of organizations that propose to further their exempt purposes by participating, as a general partner, in Internal Revenue Code (“IRC”) section 42 low income housing tax credit (LIHTC) limited partnerships.”¹ Like the April 26, 2006 “Urban Memo,” which it supersedes, the Memorandum is addressed to IRS agents processing Form 1023 or Form 1024 applications for recognition of tax-exempt status under Internal Revenue Code (IRC) section 501(c)(3) or 501(c)(4).²

The Low Income Housing Tax Credit (LIHTC) program

The low income housing tax credit (LIHTC) was created by the Tax Reform Act of 1986 (P.L. 99-514) to provide an incentive for the development or rehabilitation of affordable rental housing. The value of the LIHTC is approximately 9% of qualified basis per year for new construction, or 4% of qualified basis per year for rehabilitation or federally subsidized buildings, typically projects financed with tax-exempt bonds.³ Projects must meet two affordability tests to be eligible for credits. The first test, the “gross rents test”, requires that rents do not exceed 30% of the area’s median gross income, adjusted for family size. The second test requires that either (1) at least 20% of the units are occupied by individuals with income at or below 50% of the area median gross income (“AMI”) or (2) at least 40% of the units be occupied by individuals with income at or below 60% of AMI.

The IRS allocates LIHTCs to state housing agencies annually, according to each state’s population. State housing agencies allocate LIHTCs to developers of rental housing according to federally required, but state created, Qualified Allocation Plans (QAPs). QAPs generally give priority to projects that serve the lowest income households and that remain affordable for the longest period of time. Developers, including nonprofit organizations and limited partnerships, apply for the credits by proposing low-income housing projects to state housing agencies. Credits are awarded on a competitive basis, with the exception of 4% credits on projects financed with tax-exempt bonds, which are awarded on a non-competitive basis.

¹ http://www.irs.gov/pub/irs-tege/lihtcp_choimemo_073007.pdf.

² <http://www.irs.gov/pub/irs-tege/urbanmemo42406.pdf>.

³ Qualified basis is determined by subtracting non-depreciable costs such as land, permanent financing costs, rent reserves, and marketing costs from the total development costs of the project.

- Upon receipt of the LIHTC allocation, non-profit developers seek to sell the credits to investors in exchange for equity investments in their projects. Investors can claim the tax credits only after the real estate development is completed and operable. During the development of the project the relationship between the developer and the investor is usually structured as a limited partnership. The developer, acts as general partner, and has a small ownership percentage while maintaining the authority to build and run the project on a daily basis. The investor, as a limited partner, has a large ownership percentage but plays a passive role. With a properly-drafted limited partnership agreement, this structure satisfies the two-part test for joint ventures between exempt and non-exempt organizations set out in Rev. Rul 98-15: 1) participation in the joint venture must satisfy the tax-exempt organization's exempt purpose, and 2) the limited partnership agreement must give the exempt organization enough control to ensure that the joint venture will further its exempt purposes throughout its life.

Tax Exemption Application Process for Organizations that will Participate in LIHTC Limited Partnerships

The Urban Memo directed IRS agents to apply new standards when evaluating tax-exemption applications from non-profit developers that planned to participate in limited partnerships ("LPs") with investors. Most significantly, it required applicants to identify the specific affordable housing project the LP would develop, and required written representations that the non-profit developer's financial exposure would be limited by the terms of the LP agreement, a phase I environmental review and a fixed-price construction contract with a contractor who was bonded or able to provide a personal guarantee. The July 30, 2007 memo largely restated the Urban Memo's requirements, emphasizing the need to identify the specific project to be developed, and eliminating a requirement that applicants unable to provide final LP formation documents with their tax-exemption application submit these documents to the IRS when completed.

Specific requirements:

Item 1. The applicant must identify the specific proposed housing project to be operated by the limited partnership ("LP") and explain how the project will accomplish the organization's charitable purposes, consistent with the 'safe harbor' or facts and circumstances test for the development of affordable housing as a charitable activity, set forth in Rev. Proc. 96-32.

Item 2. Although the applicant is not required to provide a final LP agreement nor limited liability company ("LLC") governing document (formative documents), the applicant must make written representations as set forth in Item 3

Item 3. Where the applicant does not provide a formative document, it must state in writing that the formative documents will (1) specify that the LP or LLC will operate housing it owns in a manner that furthers charitable purposes by providing decent, safe, sanitary, and affordable housing for low income individuals and families (including the elderly or people with physical disabilities, where appropriate) and (2) include a provision specifying that the charitable purposes will prevail over any duty to maximize profits for the limited partners or other members.

Item 4. The applicant must adopt a conflict of interest policy to protect the applicant against possible excess benefit transactions or private inurement.

Item 5. The applicant must state the following in writing:

- (1) The applicant will review an independent Phase I environmental report on the proposed project and minimize any risk before entering into any agreements for environmental indemnification prior to entering into a formative agreement.
- (2) The applicant will require the LP or LLC to enter into a fixed price construction contract with a contractor that is bonded or that provides a performance letter of credit or adequate personal guarantee.
- (3) If the agreement requires the general partner to provide an operating deficit agreement, the agreement must:
 - a. limit the guarantee to no more than 5 years from the date the project first achieves break-even operations; and/or
 - b. limit the guarantee to 6 months of operating expenses (including debt service).

If the agreement is to include a break-even operations provision, prior to executing the agreement, the applicant will obtain a market study or undertake other due diligence to verify that break-even operations, defined as 95% occupancy and operational revenues that equal operational costs for three consecutive months following completion, are expected within a reasonable period following completion of construction.

- (4) If the formative document requires the applicant to pay the investors in the event a reduction in the amount of tax credits received by the LP or LLC occurs,
 - a. payments to be made under tax credit adjuster provisions must be limited to an amount that does not exceed the aggregate amount of the fees that the applicant (of any affiliate) is entitled to receive in connection with the project; and/or

- b. payments by the applicant will be treated as a capital contribution to the entity or as a loan, which will take priority over any other distribution of residual assets to partners upon sale or refinancing of the property.
- (5) The applicant must secure a first right of refusal to acquire the project at the end of the LIHTC compliance period and any purchase will be reviewed by the applicant's board of directors to ensure that the purchase price is reasonable and consistent with the applicant's IRC section 501(c)(3) or 501(c)(4) status.
 - (6) If the formative document requires that the general partner or managing member repurchase the investors' interest in the LP or LLC for failure to meet certain fundamental requirements related to the project's viability, such as failure to qualify for LIHTC in whole or substantial part, the repurchase price cannot exceed the amount of capital contributions.
 - (7) If the formative document requires the applicant to obtain consent of the limited partners or investor members with respect to matters not involving daily operations, such as sale of the project or transfer of the applicant's interest in the LP or LLC, such consent shall not be unreasonably withheld. Consent may be withheld if one or more of the above actions would likely be inconsistent with preserving the housing as a low-income housing project.
 - (8) If the formative document grants the limited partners or other members the right to remove the applicant as general partner, the applicant must be given written notice of any proposed removal, including the cause(s) for such action, and a reasonable time to cure the stated deficiencies.
 - The Urban Memo deletes the recommendation that agents request a copy of the final LP agreement or LLC governing document be provided upon execution. This does not affect the general partner's ability to submit an application before the partnership agreement is finalized.
 - An applicant must meet the requirements listed in Items 1 through 4, but can explain how it will satisfy an otherwise unsatisfied requirement listed in Item 5 without adversely affecting its application. Previously, applicants could provide explanations for all items where they failed to meet a requirement without adversely affecting their application. To avoid denial of the application, an applicant should ensure it meets the requirements of Items 1 through 4 prior to submitting an application.