

NOTICE

To: All Interested Parties

From: The Georgia Department of Community Affairs
Office of Affordable Housing

Re: IRS Memorandum of LIHTC Partnerships and Nonprofits

Date: May 3, 2006

On April 25, 2006, the Internal Revenue Service (IRS) published a notice regarding nonprofits who propose to further their purpose by participating in LIHTC deals as a general partner. In sum, the memorandum states and addresses the general rules that nonprofits must meet in order to pass IRS review of application for 501(c)(3) or (c)(4) exemption status.

The national law firm of Nixon Peabody LLP has published an analysis of this memorandum on their website, <http://www.nixonpeabody.com>.

DCA provides a copy of this memorandum and accompanying resource information for educational purposes only. Please consult your attorney as needed for legal advice regarding this memorandum.

This Notice is effective as of the date first given above.



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

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

April 25, 2006

MEMORANDUM FOR MANAGER, EO DETERMINATIONS

FROM: Joseph Urban *vs\ Joseph Urban*
Acting Director, EO Rulings and Agreements

SUBJECT: Low Income Housing Tax Credit Limited Partnerships

The purpose of this memorandum is to provide criteria for processing applications for recognition of exemption under section 501(c)(3) or (c)(4) of the Internal Revenue Code where the applicant proposes to further its purposes by participating, as a general partner, in a section 42 low income housing tax credit (LIHTC) limited partnership. The criteria should be applied with the understanding that applications are processed based on all the information contained in the administrative file. In addition, failure to meet a particular factor may not adversely affect an application where the applicant can otherwise describe how it will satisfy the particular concern.

1. The applicant must describe its proposed activities, including identifying the specific proposed housing project to be operated by the limited partnership. The applicant must explain how it will accomplish its charitable purposes, as an organization that provides low-income housing, consistent with the safe harbor or the facts and circumstances test set forth in Rev. Proc. 96-32, 1996-1 C.B. 717.
 - This requirement is consistent with section 5.02 of Rev. Proc. 90-27, 1990-1 C.B. 514, 516, which requires that proposed activities be described in sufficient detail to permit a conclusion that an organization qualifies for the exemption claimed.
2. The applicant is not required to provide a final limited partnership (LP) agreement or limited liability company (LLC) governing document (formative documents). However, in the absence of a final governing document, written representations will be required as discussed below.
3. The applicant must provide a written representation that the formative documents will require that charitable purposes be advanced as follows:
 - a. The formative documents will specify that the LP or LLC will operate housing that it owns in a manner that furthers charitable purposes by providing decent, safe, sanitary and affordable housing for low income persons and families (including the elderly or physically handicapped, where appropriate).

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- b. The formative documents will also include a provision specifying that in the event of a conflict between the obligations of the applicant (in its capacity as general partner or managing member) to operate the LP or LLC in a manner consistent with such charitable purpose and any duty to maximize profits for the limited partners or other members, the charitable purposes contained in the LP agreement or the LLC governing documents will prevail.
4. The applicant must adopt a conflict of interest policy to protect the applicant's interest when it is contemplating entering into a transaction or arrangement that might result in an excess benefit transaction or might benefit the private interests of the applicant's officers, directors, trustees or its partners. The sample conflict of interest contained in the *Instructions for Form 1023*, or a similar conflict of interest policy, may be adopted.
5. The applicant must provide written representations with respect to the following matters, all of which limit the applicant's financial exposure in the event the housing project does not go forward as planned. Some representations are with respect to terms and conditions that will be contained in the final formative documents. Other representations are with respect to actions that the applicant has performed, is performing, or will perform.
 - a. Prior to entering into a formative document, the applicant shall review an independent Phase I environmental report on the proposed project and exercise due diligence to minimize any risk before entering into any agreements for any environmental indemnification.
 - b. 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.
 - c. To the extent the agreement requires the general partner to provide an operating deficit guarantee, the agreement must limit the general partner's liability in one or more of the following ways:
 1. Limit the guarantee to not more than five years from the date the project first achieves break-even operations. Prior to entering into the formative documents, the applicant will obtain a market study or undertake other due diligence to verify that break-even operations for the project are expected within a reasonable period following completion of construction.
 - Break-even operations means the date upon which
 - (i) the project achieves 95 percent occupancy, and

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- (ii) the revenues received from the normal operation of the project equal all accumulated operational costs of the project for a period of three consecutive months after completion of construction computed on a cash basis and in accordance with the project and loan documents.
- 2. Limit the guarantee to six months of operating expenses (including debt service). An operating debt reserve may be established based on projected operating expenses.
- d. If the formative documents require the applicant to make a payment to the investors in the event of a reduction in the amount of tax credits received by the LP or LLC (other than any reductions to the investor's capital contributions required under the agreement) from the amount expected at the time the agreement is signed, the agreement must limit the payments in one or more of the following ways:
 - (1) Where the formative documents include separate tax credit adjuster provisions due to (i) a permanent reduction in tax credits, (ii) a timing difference in tax credits where the projected tax credits for the first year must be delayed and taken in a later year(s), and/or (iii) ongoing shortfalls or credit recapture, limit payment under each separate adjuster provision to an amount that does not exceed the aggregate amount of developer and other fees (both payable and deferred) that the applicant (or any affiliate) is entitled to receive in connection with the project.
 - (2) Provide that payments by the applicant will be treated as a capital contribution to the entity or as a loan, which shall take priority over any other distribution of residual assets to partners upon sale or refinancing of the property.
- e. The applicant must secure a right of first refusal to acquire the project at the end of the LIHTC compliance period. The applicant's board of directors shall review any purchase of the project to ensure that the purchase price is reasonable and consistent with the applicant's status as an organization described in section 501(c)(3) or (c)(4).
- f. To the extent the formative documents require that the general partner or managing member repurchase the investors' interest in the LP or LLC in the event of a failure to meet certain fundamental requirements relating to the viability of the project, such as failure to qualify for the LIHTC in whole or substantial part, failure to obtain permanent financing, and/or

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commencement of foreclosure proceedings on the construction loan, the repurchase price may not exceed the amount of capital contributions.

- g. If the formative documents provide that the applicant must obtain the consent of the limited partners or the investor members with respect to certain matters that do not involve day to day operations, including, but not limited to, the following: (i) sale or refinancing of the LIHTC project; (ii) admission of a new partner or member; (iii) acquisition of additional property; (iv) transfer of the applicant's interest in the limited partnership or limited liability company; (v) borrowing substantial additional funds; (vi) entering into contracts with affiliated entities; (vii) amendment of the limited partnership agreement or operating agreement; (viii) change of accountant or property manager; and/or (ix) approval of annual budget, then 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.
- h. Any right of the limited partner(s) or other member(s) to remove the applicant as general partner should only be for cause as set forth in the agreement or governing documents. In this circumstance, the agreement shall also require that the applicant be provided with written notice of any proposed removal, which states the cause for such action, and a reasonable period to cure the enumerated deficiencies.

You should request that applicants send a copy of the final limited partnership agreement or limited liability company governing document when executed to the Internal Revenue Service at the following address: Internal Revenue Service, P.O. Box 2508, Cincinnati, Ohio 45201.

MAY 2006

IRS Releases New Internal Memorandum on Qualifying Housing Organizations for Tax-Exempt Status

May 2, 2006

It has been exactly 10 years since the IRS issued Rev. Proc. 96-32, providing rules for low-income housing organizations that hoped to qualify as tax-exempt under Section 501(c)(3). That revenue procedure provided a “safe harbor” for those organizations involved in projects where at least 75 percent of the units were occupied by “low-income” persons, and at least 20 percent were occupied by “very-low-income” residents or 40 percent were occupied by residents with incomes at 120% of the very-low standard.

Unfortunately, over the succeeding decade, the IRS established truly burdensome procedures for the review of these organizations’ applications. Most importantly, an organization applying for tax-exempt status was generally required to provide a final partnership or LLC agreement with its application. This became an impossible “Catch 22” – few investors would negotiate this agreement without knowing that the organization was exempt, and the organization couldn’t get its exemption without negotiating the agreement. Furthermore, the IRS seemed to apply an ad hoc set of criteria to guarantees and governance rights where an exempt organization was involved, making it impossible to know whether any particular business deal would pass muster in the application process.

At long last, the IRS has circulated an internal memorandum establishing the rules it will apply to an application by an exempt organization that will serve as a general partner in a Section 42 low-income housing tax credit limited partnership. Note that, while standards (discussed below) are provided, the memorandum also states that “failure to meet a particular factor may not adversely affect an application where the applicant can otherwise describe how it will satisfy the particular concern.”



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Here is an abbreviated summary of the rules.

1. The application must be consistent with the safe harbor tests of Rev. Proc. 96-32, described above.
2. The application can include *either* a final partnership or LLC agreement *or* written representation as to certain matters that will appear in the operating agreement, in particular:
 - a. The LP or LLC will operate housing in a manner that furthers charitable purposes.
 - b. The agreement will resolve conflicts in a manner consistent with the organization's charitable purpose, which will "prevail" over any duty to maximize profits.
3. The organization must establish a "conflict of interest" policy for transactions involving its board members, officers, and partners in accordance with IRS rules.
4. The organization must represent that:
 - a. It will exercise due diligence to minimize any risk before entering into any environmental indemnification.
 - b. The LP or LLC will have a fixed price construction contract with a contractor that is bonded or provides a letter of credit or adequate guarantee.
 - c. The organization will provide an operating deficit guarantee only after conducting a market study or other due diligence, and that guarantee will (1) run for not more than five years after "break-even operations," and (2) be capped at not more than six months of operating expenses (including debt service).
 - d. Any tax credit guarantee will be capped at the amount of developer and other fees that the organization and its affiliates are entitled to receive; furthermore, the organization will get capital account credit or loan treatment for any payments made.
 - e. It will have a right of first refusal to acquire the project at the end of the compliance period at a reasonable price.
 - f. Any buyout of the investors for failure to meet funding or LIHTC qualifications will be for not more than the amount of the investors' capital contributions.
 - g. In general, any required investor consents will not be unreasonably withheld.
 - h. The organization can be removed as general partner only for cause, and only after a reasonable period to cure.

Certainly, this guidance is a welcome development after so many years without any uniform standards. Still, not every provision is easily met. And, as is often the case with IRS safe

harbors, they may well become the guiding provisions for every exempt organization that undertakes housing activities in a syndicated partnership.

Accordingly, it is important that syndicators, investors, and developers review these new rules and quickly identify those which may continue to be roadblocks to closing a successful project. Ideally, the IRS will be interested in those situations where one or more general rules of the memorandum should bend or be waived; however, the longer these provisions are in front of the housing community, the more likely they will be memorialized in a revenue procedure or regulation.

For more information about these rules and how they may affect your matters, please contact Forrest Milder, 617-345-1055 (fmilder@nixonpeabody.com), David Kavanaugh, 617-345-1134 (dkavanaugh@nixonpeabody.com), or Herb Stevens, 202-585-8811 (hstevens@nixonpeabody.com).