



Low-Income Housing Organization Ruled Taxable

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The IRS recently denied tax-exempt status to a nonprofit organization formed to encourage the development of low-income housing.¹ The nonprofit applied for tax-exempt status under Internal Revenue Code section 501(c)(3). To qualify as exempt under this section, an organization must be organized and operated exclusively for charitable purposes. The IRS concluded that the nonprofit was not operated exclusively for charitable purposes because it had a substantial non-exempt commercial purpose and operated substantially for the benefit of the private interests of investors and contractors.

The nonprofit engaged in low-income housing activities indirectly, by participating, through a wholly-owned, for-profit corporate subsidiary (the Subsidiary) in a partnership with for-profit investors (the Fund). The Fund's objective was to maximize the economic benefits provided to its investors. The Fund participated as a limited partner in other partnerships that developed, owned and operated housing for low-income tenants and provided low-income housing tax credits to equity investors. The Subsidiary was one of two general partners in the Fund. The other general partner was a for-profit subsidiary of an entity that provided asset management and other services to the Fund; that general partner was the Fund's managing general partner whose decision governed in the case of a disagreement between the two general partners. The Fund's for-profit limited partners had the right to approve of or consent to a number of major decisions about the Fund and had the right to remove the nonprofit's subsidiary as general partner in certain circumstances. In its application for tax-exempt status, the nonprofit said that it would, through the Subsidiary, operate the Fund and review and monitor the Fund's investments to be sure they met the organization's charitable objectives. In fact, however, the Fund hired third parties to perform these tasks.

Wholly-owned corporate subsidiaries and their sole shareholders are generally treated as separate taxable entities. Therefore, in deciding whether the nonprofit qualified for exempt status, the IRS focused on the activities of the nonprofit organization, rather than the Subsidiary. The nonprofit's activities consisted of providing support and guidance to the for-profit Subsidiary and providing consulting or administrative services to the Fund for a fee. According to the IRS, neither of these activities qualified as charitable.

The IRS also concluded that, even if the Subsidiary's activities could be considered those of its parent, the parent could not qualify as exempt, since the Subsidiary's activities substantially benefited the for-profit partners and contractors involved and thus did not qualify as exclusively charitable. In reaching this conclusion, the IRS cited the following facts:

- ***The Fund was the nonprofit's only activity*** - The nonprofit's activities and those of its Subsidiary were limited to investing in and getting investors for the Fund, whose purpose was to maximize economic benefits for its for-profit investors.
- ***The nonprofit did not control the Fund*** - The Fund's managing general partner, an unrelated for-profit, had the final say if the two general partners disagreed. The Fund's for-profit investors had the right to remove the Subsidiary as general partner under certain circumstances. Day-to-day control of the Fund was contracted out to unrelated for-profits. Moreover, the partnership agreements of the Fund and the housing partnerships in which it was to invest did not give priority to charitable purposes over investors' goals.
- ***The nonprofit's board members had potential conflicts of interest*** - Some of the nonprofit's board members were affiliated with corporations that planned to invest in the Fund for a profit. Other board members represented private interests that stood to benefit from the nonprofit's investments.

This ruling is consistent with the IRS's position on "whole entity" joint ventures, which requires that in situations where a nonprofit's only activity is to participate in partnership with a for-profit, the nonprofit must retain control over the partnership in order to qualify for exempt status.² The ruling also underscores the fact that, in order for a nonprofit that serves as the general partner of a low-income housing tax credit partnership to qualify for exemption, the partnership arrangement must be carefully structured to avoid excess benefit to private parties, including the partnership's for-profit limited partners, and to protect the nonprofit general partner's charitable assets over private investors' interests.³

¹ PLR 200502046 (Oct. 18, 2004).

² See Rev. Rul. 98-15, 1998-1 C.B. 718.

³ See IRS 2003 Exempt Organizations Continuing Professional Education (EO CPE) Text "[Housing Partnership Agreements](#)" and 1996 EO CPE Text "[Recent Developments in Housing Regarding Qualification Standards and Partnership Issues](#)".