

GCM 39005 (IRS GCM), 1983 WL 197944

Internal Revenue Service (I.R.S.)
General Counsel Memorandum

Date Numbered: June 28, 1983
Dec. 17, 1982

This GCM relates to a ruling letter that is exempt from disclosure under section 6110(k).

CC:EE-58-82

Br2:JPainter

TO: S. ALLEN WINBORNE

Assistant Commissioner (Employee Plans and Exempt Organizations)

Attention: Director, Exempt Organizations Division

This responds to your memorandum (OP:E:EO) dated May 14, 1982, requesting our concurrence or comments on a proposed ruling letter to the above organization.

ISSUE

Whether a nonprofit organization that enters into a limited partnership as one of several general partners for the purpose of constructing, owning, and operating a federally assisted apartment complex for handicapped and elderly individuals of limited income may qualify as an organization described in [I.R.C. s 501\(c\)\(3\)](#).

CONCLUSION

An exempt organization may qualify under [section 501\(c\)\(3\)](#) notwithstanding its participation in a limited partnership as one of several general partners if the partnership arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted. We believe that, in this case, both the federally imposed restrictions and the structure of the partnership agreement are sufficient to protect the nonprofit organization from any potential conflict between its partnership obligations as a general partner and its exempt goals. Accordingly, we agree with your conclusion that the organization may qualify under [section 501\(c\)\(3\)](#).

FACTS

*** (the Corporation) was organized in the State of *** as a not-for-profit corporation on ***. The Corporation is governed by a *** member Board of Trustees; *** selected by the local *** and *** selected by area ***.

The purpose of the Corporation, as recited in its Articles of Incorporation, is:

To provide for the elderly families and elderly persons on a non-profit basis rental housing and related facilities and services specifically designated to meet the physical, social and psychological needs of the aged, and to contribute to their health, security, happiness, and usefulness in longer living.

To further this purpose, the Corporation has become a general partner in a limited partnership formed to construct, own and operate a federally financed apartment project for the city's limited income handicapped and elderly. There are *** other general partners, all for-profit entities. There are also numerous individual limited partners who are obligated solely to contribute capital and who will be entitled to a *** preferential cash distribution on their original cash contribution.

The partnership will participate in a Housing and Urban Development (HUD) Section 8 rent subsidy program. Under this program, the partnership has entered into a Housing Assistance Payments Contract (HAP Contract) through which HUD will make rental assistance payments to the partnership on behalf of qualified tenants. A qualified tenant must be either handicapped or at least 62 years old and meet certain income limitations, thus insuring that only moderate or low income persons will be eligible. Rent will be partially paid by the tenant based on a percentage of adjusted monthly income (not to exceed 25 percent). The difference between the tenant's portion and the contract rent will be paid directly by HUD to the partnership. The project will hold 100 percent of the rental units open to families eligible for Section 8 subsidies.

*2 The HAP Contract is for a term of five years which is renewable by the partnership in five year increments for a maximum period of twenty years. The partnership has indicated that it will renew its HAP Contract for the full twenty year term. The federally insured mortgage on the project, however, will be amortized over forty years. Thus, the housing assistance payments will cease prior to any substantial amortization of the principal amount of the mortgage.

Under the partnership agreement, the Corporation's responsibilities will include marketing and renting units, enforcing leases, supervising maintenance and repairs, and conducting social service programs for residents. All of these activities will be initially carried out with the guidance of a consulting firm, as no trustee in the Corporation has any substantial prior experience in housing, partnership, real estate or financial matters. The Corporation will develop a program to attract minority tenants. The Corporation will be responsible for social service and recreational programs for tenants. Programs with outside agencies such as Meals On Wheels and the Visiting Nurse Program will be developed. The Corporation also indicates that there will be an on-site dining facility to provide meals, a large community room and a bus or van for transportation. The Corporation will be responsible for all tenant-management relations and all on-site management facilities.

The Corporation, and one other general partner have been designated as the managing partners. The agreement provides that the managing partners may allocate duties and responsibilities as they see fit. The Corporation is guaranteed the right of first refusal to purchase the project when it is offered for sale. The Corporation has made only nominal contributions to capital.

Profits, losses and operating cash flow will be allocated *** to the limited partners and *** to the general partners. Profits and cash flow from sales or refinancing will be allocated *** to the limited partners and *** to the general partners. The general partners' share of profits, losses and cash flow from either operations or from sale, exchange or refinancing will be allocated *** to the for-profit general partners and *** to the Corporation. The for-profit general partners have agreed to provide funds to cover any operating deficits until ***.

For its services in developing the project, the for-profit managing general partner will be entitled to both a development fee from excess capital contribution or other funds and, ***. For any year in which the for-profit managing general partner is not receiving *** the consulting firm, which is controlled by the for-profit managing partner, will be entitled to receive an incentive management fee equal to *** of the project's excess cash flow after payment of the limited partners' *** cash distribution. However, in consideration of the management duties that will be undertaken by the Corporation, *** of the fees paid to the consulting firm (including the incentive fee) will be allocated to the Corporation for the first ***. Thereafter, fees will be allocated in accordance with the responsibilities assigned to each.

ANALYSIS

*3 [Section 501\(a\)](#) and [501\(c\)\(3\) of the Code](#) provide for the exemption from federal income tax of organizations organized and operated exclusively for charitable purposes, no part of the net earnings of which inure to the benefit of any private shareholder or individual.

[Treas. Reg. s 1.501\(c\)\(3\)-1\(d\)\(2\)](#) provides that ‘the term ‘charitable’ is used in [section 501\(c\)\(3\)](#) in its generally accepted legal sense’ and includes ‘relief of the poor and distressed’ and the ‘promotion of social welfare.’

[Treas. Reg. s 1.501\(c\)\(3\)-1\(e\)](#) provides that:

An organization may meet the requirements of [section 501\(c\)\(3\)](#) although it operates a trade or business as a substantial part of its activities, if the operation of such trade or business is in furtherance of the organization's exempt purpose or purposes and if the organization is not organized or operated for the primary purpose of carrying on an unrelated trade or business, as defined in section 513. In determining the existence or nonexistence of such primary purpose, all the circumstances must be considered, including the size and extent of the trade or business and the size and extent of the activities which are in furtherance of one or more exempt purposes.

[Treas. Reg. s 1.501\(c\)\(3\)-1\(d\)\(1\)\(ii\)](#) provides that an organization is not organized or operated exclusively for any of the purposes specified in [section 501\(c\)\(3\)](#) unless it serves a public rather than a private interest. Thus, to qualify under [section 501\(c\)\(3\)](#), an organization must establish that it is not organized or operated for the benefit of private interests such as designated individuals, the creator or the creator's family, shareholders of the organization, or persons controlled, directly or indirectly, by such private interests.

In requesting clarification in this area, you noted in your memorandum of May 18, 1982, that it was difficult to reconcile * *, O.M. 19225, EE-7-80 (March 13, 1980) which permitted an exempt organization to participate as a general partner in a limited partnership established to build and manage a moderate and low income housing project with the denial of exemption to an organization involved in substantially the same activity in * * *, [G.C.M. 36293, I-214-73 \(May 30, 1975\)](#). Although you propose to issue a favorable ruling in this case, you nevertheless expressed concern that participation by an exempt organization in any partnership arrangement would substantially promote the private interests of the limited partners.

As we indicated in O.M. 19225, an exempt organization's participation in a partnership arrangement as a general partner should not *per se* result in denial of [section 501\(c\)\(3\)](#) status. The partnership arrangement, however, should be closely scrutinized to assure that the statutorily imposed obligations on the general partner do not conflict with the exempt organization's ability to pursue its charitable goals. Thus, in all partnership cases, initial focus should be on whether the organization is serving a charitable purpose. Once charity has been established, the partnership arrangement itself should be examined to see whether the arrangement permits the exempt organization to act exclusively in furtherance of the purposes for which exemption may be granted and not for the benefit of the limited partners.

*4 In the instant case, the Corporation's participation in the building and management of a government-financed housing project for the handicapped and elderly serves to further charitable purposes. As a direct result of the Corporation's participation, 100 percent of the units will be held open to elderly or handicapped individuals with limited incomes (although the government subsidy program requires that only 85 percent of the units be made available to these tenants). Moreover, the Corporation will conduct numerous programs to meet the physical, social and recreational needs of this group. The Service has held that an organization which undertakes these activities is operating exclusively for charitable purposes. *See e.g.*, [Rev. Rul. 79-18, 1979-1 C.B. 194](#); [Rev. Rul. 79-19, 1979-1 C.B. 195](#), [Rev. Rul. 72-124, 1972-1 C.B. 145](#).

The organization in [G.C.M. 36293](#) could not establish that its participation in the government-sponsored housing project would have actually served a recognizable [section 501\(c\)\(3\)](#) purpose. First, only * * * of the proposed * * * housing project were designated for low income individuals (* * * units were designated for moderate income tenants). Thus, the project could not

be said to be relieving the poor or distressed. Second, the project was to be located in an affluent, predominantly white suburb consisting exclusively of single family dwellings with no indication of decay or community tension. Therefore, the project could not have been characterized as charitable on the basis of combating community deterioration or relieving neighborhood tensions. Accordingly, the organization failed to demonstrate any charitable purpose for its involvement in the partnership.

In contrast to [G.C.M. 36293](#), the organization in O.M. 19225 was formed to foster and develop a government- sponsored low and moderate income housing project in a riot-torn inner city ghetto. The organization demonstrated that its activities would combat community deterioration, juvenile delinquency and neighborhood tensions, all recognized charitable purposes. In addition, federally imposed income limitations were placed on eligible applicants for the housing, indicating that profits were an unlikely motivation for the organization's involvement in the venture.

Notwithstanding an established charitable purpose, however, conflicts with charitable goals can nevertheless arise in a limited partnership situation because certain statutory obligations are imposed upon a general partner. These obligations include an assumption of all liabilities by the general partner and a basic profit orientation in the interest of the limited partners. Thus, unless an exempt organization, acting as general partner, can insulate itself from these obligations, conflicts exist which will preclude exemption.

In [G.C.M. 36293](#), the organization failed to demonstrate that it was so insulated. The organization was to serve as the sole general partner in the project and there was no evidence that its obligations were in any way limited or restricted in the agreement. Accordingly, we stated,

*5 By agreeing to serve as the general partner of the proposed housing project, the Corporation would take on an obligation to further the private financial interests of the limited partners. Since the promotion of those private interests would tend to foster operating and maintenance practices favoring the equity holdings of the limited partners to a greater extent than would otherwise be justifiable on the basis of reasonable financial solvency, the Corporation's assumption of a duty to promote such interests in its capacity as general partner would necessarily create a conflict of interest that is legally incompatible with its being operated exclusively for charitable purposes.

The partnership agreement may, however, be structured to preclude a conflict of interest between the nonprofit general partner's obligations and its exempt purposes. Both in O.M. 19225 and in this case, the partnership agreement recognizes that the obligations and responsibility of the exempt general partner are limited. In both cases there are other general partners. The exempt organization has the right of first refusal if the property is offered for sale. Risk is further reduced in the present case because the Corporation has no liability on the mortgage and the mortgage loan is federally guaranteed. The potential for conflict is further reduced because only the other nonexempt general partners have the obligation to protect the interest of the limited partners. Moreover, because of federally imposed income limitations, pursuit of profit cannot be established as a motivating factor for the exempt organization's participation in this venture.

Although it may be argued that a profit-motive is served by the incentive management fee arrangement in which both the consulting firm and the Corporation participate, percentage compensation arrangements are not, in themselves, a bar to exemption. In O.M. 19225, we stated that 'a reasonable percentage compensation agreement is not inconsistent with the pursuit of exempt purposes.' The method of compensation in this case appears reasonable because payments are directly related to services rendered. Moreover, all tenants are of limited means and government guidelines restrict the profits obtainable from the project.

Another potential conflict between the for-profit partners and the Corporation may exist when the rent subsidies and the tax benefits expire. Accelerated depreciation for Section 8 low income housing is provided under section 167(k). However, under section 1250, excess depreciation is subject to full recapture if the property is held for less than 100 months, with recapture decreasing by one percent for each month the property is held beyond 100 months so that there is no recapture after $16\frac{2}{3}$ years. For the project to qualify as government- subsidized housing for tax purposes, 85 percent of the dwelling units must be

held open for occupancy by persons eligible to receive the Section 8 subsidy. After 16-²/₃ years, when the recapture rules are no longer applicable, pressure to sell may be expected. Moreover, after 20 years, the Section 8 subsidies will lapse and pressure to raise rents may be expected. In both O.M. 19225 and here, this pressure is minimized by permitting the exempt organization a right of first refusal on sale of the project.

*6 We believe that under the facts of this case, as in O.M. 19225, the potentials for conflict are minimal. The restrictive provisions of the HUD programs and the structure of the partnership agreement function to permit the Corporation to act exclusively in furtherance of [section 501\(c\)\(3\)](#) purposes. We therefore concur in the issuance of a favorable ruling.

JAMES F. MALLOY
Director

By:

HARRY BEKER
Assistant Branch Chief, Branch No. 2
Employee Plans and Exempt Organizations Division

Attachment

Adm. file

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