ISSUES FOR NONPROFIT CORPORATIONS CONSIDERING

PARTICIPATING IN LOW INCOME HOUSING TAX CREDIT PROJECTS[1]

A. Introduction

1. This is a complex area of law with arcane rules and it is not possible here to delve into the more technical legal aspects of using the LIHTC Program. What we are attempting to do is to explain the various roles to be played in a LIHTC project, the benefits to participation in such a project, the risks inherent in such participation, what a nonprofit ("NP") should consider in choosing whether and how to participate in a LIHTC project and how to structure nonprofit participation.

2. For the sake of this discussion we will assume that you (the audience or reader) have a basic understanding of the LIHTC Program and how it creates funding for low income housing.

3. While the LLC format can be used, this discussion assumes that the LIHTC project will be owned, as is usually the case, by a limited partnership. A limited partnership is a legally recognized entity established under the guidelines of state law consisting of one or more limited partners and one or more general partners. Limited partnerships are pass through entities, which means that the benefits and risks pass through to the partners as allocated in the partnership agreement.

B. Roles In LIHTC Project Development and Operation - Who Does What?

1. **Limited Partner(s)** - invests money, controls terms of partnership agreement, gets limited control of design and structure of project as condition to making investment (i.e. only makes investment if satisfied with design and structure of project) and cannot be involved in management and day-to-day decision making of partnership.

   a. **advantages** - usually gets 99 - 99.99% of tax credits, losses and cash flow, and a portion of residual value; liability limited to money invested.
   b. **disadvantages** - limited control of project, especially after initial closing.

[1] This outline was written by Mark E. Levin, Chief Counsel of Regional Housing Legal Services. RHLS is a statewide tax exempt nonprofit corporation which provides legal and technical assistance to nonprofit corporations producing low income housing or carrying out economic development projects for low income communities. In that capacity RHLS has participated in over fifty LIHTC projects.

2. **General Partner(s)** - responsible for carrying out purposes of the partnership and making day-to-day decisions, overall management and control of the business, assets and affairs of the partnership, ensures compliance with requirements of LIHTC program and financing documents, supervises management agent and may invest in project (some projects require investment by general partner).

a. **advantages** - power to make decisions for partnership - hiring, budgets, contracting, management, landlord-tenant issues; often given right to purchase property after compliance period at nominal cost (this right is often extended to affiliates of GP or sponsor).

b. **disadvantages** - unlimited liability, obligation to make up difference between anticipated and actual tax benefits to LP (if tax benefits are reduced the limited partner may reduce its capital contribution and the GP will have the obligation to provide the funds necessary to meet project costs which were to be met with the withheld/repaid capital contribution), obligation to make cash flow loans, ensure completion of project, obligation to purchase limited partnership interests under certain conditions, environmental indemnification, tax credit compliance responsibility, reporting to investors and funders.

3. **Developer** - Responsible for putting together and overseeing work of development team (architect, contractor, accountant, lawyer, consultant, management agent), getting site control, obtaining all necessary governmental approvals, obtaining necessary funding, negotiating financing documents, determining design and scope of construction, negotiating and enforcing contracts and ensuring construction completed in good and worker-like manner, on time and within budget. The same party usually serves as developer and sponsor.

a. **advantages** - earns developer's fee (in Pennsylvania generally limited to 15% of replacement cost for projects of 25 or more units and 20% for smaller projects - note that any consultants fee comes out of this amount), primary control of all aspects of project design and development, liability limited to potential loss of part of fee but no partnership liability or money at risk.

b. **disadvantages** - only downside, if it can be called that, is that developer is largely responsible for success or failure of project.

4. **Sponsor/Guarantor** -Since these partnerships are usually established with a general partner with very limited assets and significant financial obligations, the sponsor must guarantee payment of the general partner's obligations. Where NP serves as sponsor it usually also serves as developer and in return gets a developer's fee, thus mitigating the disadvantage of financial obligations. Note that when the NP serves as guarantor it should also at least nominally serve as developer even if it actually hires one or more consultants to serve that function. In that way it will generate developer fee "income" to put at risk providing those guaranties and thus, at

least in IRS' eyes not put charitable assets at risk.

5. **Management Agent** - Responsible for renting and maintaining units, ensuring units rented to households with appropriate incomes (requirements of tax credit program - project must have minimum of either 20% of occupant households with incomes 50% of median household income for "area" or less or 40% of occupant households below 60% of median and all households residing in units for which tax credits obtained must not have incomes exceeding 60% of median; in order to compete for tax credits applicants often promise to put aside a certain number of units for households at 20%, 40% and/or 50% of area median income; other funding sources may have other income requirements), drafting annual operating budgets, enforcing leases, evictions, paying mortgage(s) and all bills out of operating income, keeping financial records and collecting rents. Gets fee equal to 6-10% of gross income.

6. **Special Limited Partner** - Serves a special role in project - e.g. provides political muscle necessary to get required approvals and/or funding, serves as nonprofit necessary for competing for tax credits, lends reputation or stamp of approval to project/developer. In return special limited partner gets a share of the developer's fee and/or some say in design of project or selection of tenants. Investors often have an affiliate corporation serve as a special limited partner to provide oversight of the project.

7. **Lender** - NP can raise money for the project from foundation and governmental sources and lend it to the partnership. Such funds are normally provided as deferred payment mortgage loans and can provide a means for a certain level of oversight regarding project operations.

C. What Should Nonprofit Consider Before Deciding How It Will Participate In LIHTC Project?

1. **What benefit(s) does the NP want out of the project?** - create the low income units, fix up neighborhood, money, selection of tenants, degree of control of the development process, degree of control of partnership management issues, degree of control of rental management issues, gain reputation as a developer of multifamily housing, learn how to do this type of development.

2. **What risks/burdens is the NP willing to bear?** - financial, having to ensure long-term compliance, reporting requirements, reputation if project fails, tax exempt status.

3. **What are the NP's strengths and weaknesses?** - does it have the staff and experience necessary to fill developer or management agent roles, does it have financial strength necessary to serve as sponsor, does it have political strength necessary to obtain necessary approvals and financing, what is its development experience and reputation, does it have means necessary to pay for predevelopment costs, does it have ability to negotiate investor participation or access to appropriate consultant.

4. **What are the NP's goals?** - to be a developer of low income housing, to provide social services to low income people, to revitalize a particular community or property, to

facilitate revitalization, to organize residents of a neighborhood in support of things that aid neighborhood and against those that harm neighborhood.

5. The answers to those questions will determine how the NP should participate in the LIHTC Project. For example: if it wants to raise unrestricted funding to help support the NP's operating costs and has the requisite staff/experience then it should participate as a developer and sponsor; if it wants to control development and operating issues but it doesn't have the staff or expertise to serve as the developer or management agent, it should participate as the general partner (through an affiliate corporation) and sponsor - assuming it is willing to take the financial risk; if it is primarily interested in selecting and working with the tenants it may want to just participate as the management agent; if it just wants to see project built and has political muscle it may want to serve as a special limited partner.

D. Structuring NP Participation

1. NP can fill one or more of the roles noted above. The NP may act in its own right or through a nonprofit or business corporation it creates for that purpose, and may be involved either on its own or jointly with another unrelated entity.

2. **General Partner** - If tax exempt nonprofit wants to participate as a general partner, it should either shift financial guarantee risks of that role to a co-general partner and limit its role to one related to its charitable purposes <u>or</u> negotiate limits on certain financial guaranties <u>or</u> create a separate corporation to serve as the GP.

(a) The IRS position on participation of tax exempt entities in joint ventures/partnerships with for profit entities has been, and continues to be, evolving over the last few years. IRS' concerns center on whether: the tax exempt entity's participation is related to its charitable purpose, charitable assets are exposed to unnecessary or unwarranted risks, and there is an unacceptable level of private inurement. It is clear that creation of low income housing (often including removal of slums or blight) is charitable but the tax exempt entity must exercise sufficient control of the day-to-day operations of the partnership to ensure that the charitable goals are met. The type of guaranties required of the general partner (and the sponsor which backs up the obligations of the general partner) can put the charitable assets of the tax exempt entity at risk. IRS is willing, however, to look at the specific facts of the situation to see whether the risk is substantial or more apparent than real. The guaranties can also be drafted so as to not permanently put assets at risk by limiting the amount and time of the guaranties and by having money paid as a result of a guaranty deemed to be a capital contribution or a loan. These partnerships will necessarily involve some private benefit but IRS has provided guidance regarding how to limit certain guaranties and thus avoid risk to the non-profit's charitable status.

(1) The most recent iteration of IRS guidance for exempt

organizations participating in such projects came in the form of a memorandum (Choi Memorandum, July 30, 2007). Mr. Choi provides guidance on how an exempt organization can limit its risks and how certain typical guaranties and limited partnership agreement provisions should be structured to protect the organization's exemption:

(i) review an independent environmental assessment
(ii) enter into a fixed price construction contract with either performance and payment bonds or an adequate letter of credit from the contractor.
(iii) limit operating deficit guaranty to not more than five years from project breakeven and/or limit the guaranty to no more than six months of operating expenses.
(iv) limit each credit adjuster (where less credits delivered or more credits delayed than projected, investor can reduce capital contribution and GP or sponsor must make payments to replace the lost funds) to aggregate of developer's fee and other fees paid to NP and affiliates.[2]
(v) secure a right of first refusal to acquire the project after the compliance period (initial 15 years).
(vi) where the limited partnership agreement requires repurchase of the limited partner's interest on the occurrence of certain failures, the purchase price cannot exceed the amount of the capital contributions.
(vii) the limited partnership agreement can be written to require the investor's consent to certain decisions but such consent must be given unless the proposed actions are inconsistent with preserving the housing as a low income project.
(viii) the general partner should only be removed for cause and only after a reasonable period for cure.

(b) If an tax exempt entity is a partner in a LIHTC project, the project is deemed to be "tax exempt use property". Such a designation means that the benefits of partnership (credits, losses, residual value) cannot be disproportionately allocated (e.g. partners get one percentage of credits, cash flow and losses and a different percentage of residual value) unless the portion of the property attributed to the tax exempt entity is depreciated over 40 years instead of the usual 27 ½ years. This reduces the equity that can be raised from the investor(s).

(c) The tax exempt nonprofit can form a business corporation to serve as the general partner, which it controls through ownership of a majority of its stock. If the tax exempt entity owns 50% or more of the stock, the

[2] I believe that Mr. Choi's guidance does not adequately protect the exempt organization and that IRS's position will evolve to provide better guidance on structuring the credit adjusters.

business corporation will be deemed to be a tax-exempt controlled entity [IRC §168(h)(6)(F)] and will be treated as a tax exempt entity for purposes of the tax exempt use provisions. The corporation can avoid such treatment by making an election under IRC §168(h)(6) to have any dividends paid to parent NP taxed as unrelated business income. A majority of the Board members of this corporation should not also be on parent NP's Board and the corporation should observe all corporate formalities (i.e. separate Board meetings, separate financial records, minutes, etc.). Even though the corporation is unlikely to earn any money as a general partner, it will be liable for annual minimum Pennsylvania tax of $300.

(d) The tax exempt entity can form a nonprofit non-exempt corporation to serve as general partner and can control it by appointing a majority of its Board of Directors. As was true of the business corporation, this new corporation should observe the corporate formalities and a majority of its Board should not also sit on the parent NP's Board. This route will avoid any Pennsylvania corporate taxes as long as the corporation is <u>eligible</u> for federal tax exempt status. This corporation should also make the IRC §168(h)(6) election noted above.

(1) The tax credit statute requires each state allocating agency to set aside 10% of its annual tax credit allocation for "qualified nonprofit organizations" [IRC Section 42(h)(5)]. A "qualified nonprofit organization" must be exempt under Section 501(c)(3) or 501(c)(4), not be affiliated with or controlled by a for profit entity and must have "fostering low income housing" as one of its exempt purposes. To qualify for the set-aside the qualified nonprofit organization must own an interest in the project and materially participate in the operation of the project for the compliance period, or a wholly-owned subsidiary of one or more qualified nonprofit organizations can serve as the general partner and meet the ownership and participation tests. If a qualified nonprofit organization developer plans to apply for the set-aside, I recommend that it form either a for-profit or nonprofit stock corporation to serve as the general partner and establish ownership through purchase of its stock. Note that it may also be possible to achieve the same purpose by creating a membership corporation as the GP with the qualified nonprofit organization as its only member - if IRS would deem such a corporation to be "wholly owned" by a qualified nonprofit.

(e) If the NP, or its affiliated corporation, participates as a co-general partner with the financial risks shifted to the other general partner, it should expect that corporation to share in the developer's fees generated by the project. If the co-general does not have assets substantial enough to satisfy the investors and lenders that it can bear the financial risks, a sponsor will still have to guarantee the general partner's obligations.

3. **Special Limited Partner** - The NP can participate in this role but should have the partnership agreement state that it is participating in furtherance of its charitable purposes (e.g. foster low income housing, revitalize deteriorated community). A limited partner may be a contractor or consultant to the partnership without losing its limited liability status.

4. **Nonprofit as limited partner** - As NP cannot use the tax credits or losses generated by a LIHTC project, it makes little sense to participate directly as an investor (as compared to a lender). If the NP wants to invest in the project, rather than lend money to the project, it could do so through a business corporation. The NP could invest in the business corporation through stock purchase and that corporation could become a limited partner in the project. The tax credits and losses allocated to the business corporation could offset its tax burden from its other enterprises. The NP can also "invest" in the NP general partner by a stock purchase or by making a capital contribution or subvention as allowed by Pennsylvania law. These are forms of "investment" that do not return the principal until dissolution of the corporation.

5. **Nonprofit as the sponsor of a LIHTC project** - Nonprofit development corporations commonly take this role in a LIHTC project to guarantee the obligations of their affiliate corporations which are serving as general partners. This is necessary because the affiliate corporations typically have no assets other than what they have invested in the project.

6. **Nonprofit as the developer** - The development of low income housing is a charitable enterprise and thus is perfectly suited to a tax exempt nonprofit. If the NP does not have the experience and staff necessary to fully carry out the developer role it can either hire the appropriate consultants or joint venture with another entity and share the developer's fee. Joint venturing is an excellent way for a relatively inexperienced NP to gain development experience.

(a) If a nonprofit corporation wants to joint venture with a for-profit entity, there are various things to address in the negotiation. The joint venture agreement should expressly recognize the NP's charitable purposes and provide the nonprofit with the opportunity to advance those purposes. The NP should seek sole or joint decision making authority on those issues it deems most important. Other issues to be negotiated include: which entity is responsible for providing the required guaranties, which entity is responsible for funding pre-development costs and how should the developer's fee be split between the joint venturers. Factors that often determine the split of developer's fee include: who has the necessary political power to get needed approvals and funding, who controls the property, who is providing the guaranties, who will be accomplishing the development tasks and will the project be applying for the nonprofit set-aside.

7. **Nonprofit as the management agent** - The management of low income housing is <u>not</u> a charitable activity. If such management is the primary activity of the NP or provides a substantial part of the NP's funding it can threaten the NP's tax exempt status. If the NP is

primarily a developer of low income housing or a provider of social services to low income tenants, for example, which manages low income housing to better achieve its development or social service goals, its tax exempt status should be safe.

8. **Nonprofit as lender** - It is perfectly acceptable for a tax exempt entity to lend money to a for profit entity for the purpose of developing low income housing. This role is most often used where the NP is also serving as the developer and/or sponsor.

E. Ownership by the Nonprofit After the Compliance Period

The Partnership Agreement may contain an option to purchase and a right of first refusal by the General Partner or its affiliates (i.e., its parent NP) to purchase the property at the end of the compliance period. Options are usually written for the greater of the fair market value of the property as low income housing or the statutory minimum purchase price. According to the statute, the purchase price the parties agree on as they enter into the partnership may not be less than the principal amount of any outstanding indebtedness secured by the building plus all federal, state, and local taxes attributable to the sale. A right of first refusal is generally written for the statutory minimum purchase price. At the time of acquisition, the purchase price is effectively reduced by any loans owed to the NP. Since some of the loans to the partnership are likely to be deferred payment loans from governmental agencies, the NP may be able to assume the loans, further reducing the acquisition price. As tax credit projects reach the end of their initial 15 year compliance periods, some investors are choosing to donate their limited partner interests to the qualified non-profit corporation rather than sell that interest under the option or right of first refusal.

F. Conclusion

The Low Income Housing Tax Credit program is the primary vehicle for the development of low income rental housing. If a nonprofit corporation wants to develop, or participate in the development of, such housing it should consider participating in a tax credit project. This is a legally complicated area and one into which no nonprofit, or for-profit for that matter, should venture without serious thought, adequate counsel, either experienced development staff or development consultant and a property manager with experience managing tax credit projects.