

Advanced Topics in Low Income Housing Tax Credits

(Clifton Hall)

Biographical Information

Tim Flaherty, CPA is the managing partner of Salmin, Celona, Wehrle & Flaherty, LLP, CPAs and also heads up the affordable housing practice of the firm. Tim's clients include approximately 200 real estate entities most of which are low-income housing tax credit properties. His involvement with these entities includes consulting in the various aspects of affordable housing development and management as well as traditional compliance related services. Tim is a member of NYSAFAH, CARH, NYSRRHA, AHACPA, the AICPA and the Nevada State Society of CPAs. Prior to joining the firm, Tim was an audit manager at Coopers & Lybrand (now PricewaterhouseCoopers) in Rochester. Tim is a 1982 graduate of St. Bonaventure University. Tim was also an adjunct professor at St. John Fisher College in Rochester from 1986 to 1992.

Jim DeBellis is a partner of Salmin, Celona, Wehrle & Flaherty, LLP, CPAs in Rochester. Jim heads up the Tax Department of the firm. Jim has 15 years of experience in the affordable housing sector in the area of Low Income Housing Tax Credit compliance and planning. He also concentrates heavily in the area of Partnership taxation as well as traditional planning and compliance related services in the areas of small business, individual and estate taxation. Jim is a member of, the AICPA. Prior to joining the firm, Jim was a Tax manager at two other local accounting firms in Rochester Jim is a 1982 graduate of Niagara University.

Tim Favaro concentrates his practice in the areas of community development, affordable senior and multi-family housing development, and commercial property development utilizing various tax driven development incentives including, among others, the Low-Income Housing Tax Credit, the New Market Tax Credit, the Federal and New York Historic Tax Credit and the New York State Empire Zone program. Mr. Favaro is from Ithaca, New York and he is a graduate of the State University of New York at Buffalo School of Law. Mr. Favaro joined the law firm of Cannon Heyman & Weiss, LLP in May of 2004.

Raymond P. Reichert is a partner in the Firm's Tax and Economic & Land Development practice groups. He has devoted substantially his entire career to the practice of tax law with a primary focus on partnership and LLC taxation, including syndication of housing tax credits and historic tax credits. He also represents publicly traded Real Estate Investment Trusts in equity financing and investment transactions utilizing LLC's. . In addition, his practice includes structuring real estate joint ventures, low income housing and economic development planning. From 1990 to 1992, he held the position of Adjunct Assistant Professor of Law at the State University of New York at Buffalo School, where he taught the basic federal income tax course, and for several years taught the partnership tax course. He has lectured on numerous occasions with regard to tax and economic development related subjects. Mr. Reichert holds a B.A. from Fordham University and a J.D. State University of New York at Buffalo.

**Upstate New York Affordable Housing Conference – 2008
Speakers & Topics for Advanced LIHC Breakout Session
September 23, 2008**

Moderator:

Timothy R. Flaherty, CPA

Partner

Salmin, Celona, Wehrle & Flaherty, LLP CPAs in Rochester, NY

Speakers:

Tim M. Favaro, Esq

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Session breakouts:

1) Not-for-profit (NFP) involvement & NFP controlled GP entities (**Tim Favaro**)

I. Background

II. Application for Recognition of Exemption – IRS April, 2006 and July, 2007 Memoranda

III. IRC 168(h)(6) Election – What is it and why is it needed?

IV. Combining Federal Low Income Housing Tax Credits with Federal Rehabilitation (AKA
Historic) Credits.

V. Miscellaneous Tax Exempt Issues (time permitting).

2) Tax Credit Issues (Level 200) (**Jim DeBellis**)

- Navigating through the various rules and issues regarding first year credit calculations for acquisition/rehab projects
- Discussion of acquisition credit issues including the 10 year hold rule and related party ownership rules..
- Effect of federal grants and below market interest federal loans.

3) Partnership Tax Issues (**Ray Reichert**)

- General discussion of tax allocations, including substantial economic effect test, capital accounts, deficit restoration obligations, minimum gain, and qualified income offsets.
- Special allocation issues, including special allocations of LIHTC and losses.
- Treatment of debt, including recourse and nonrecourse debt, after acquired debt, and excess debt.

4a) Facilitate Q&A (**Tim Flaherty**)

4b) If time permits: Talk about attorney/ accountant coordination and communication

Attorneys are on the front end of the deal

Accountants are on the tail end

Cost cert

1st year LIHC and tax return

168(h) election

LP interest assignment after deal closes

Development fee earned (especially for 10% carryover allocation cert)

Amount at closing

Documenting amount earned

**Other LIHC Areas and Q&A Portion
Advanced LIHC Breakout Session
Upstate Conference – Buffalo
September 23, 2008**

Tim Flaherty, moderator for the Advanced LIHC Breakout Session

Covered by the presenters:

- Not-for-profit involvement
- IRS memorandums providing safe harbor provisions for 501©(3) exemptions
- Combining LIHC with certified historic rehabilitation credit
- IRC Sec 168(H)(6) elections and provisions
- First year LIHC calculations
- 10 year hold rule
- Related party rules
- Grants and below market interest rate federal sourced loans
- Partnership tax allocations including:
 - Substantial economic effect
 - Minimum gain
 - Special allocations
 - Treatment of debt

Other Areas not covered today:

- Coordination of the team, especially the attorneys and the accountants:
 - Attorneys typically at the front end/deal creation
 - Accountants usually at the tail end (cost certs, LIHC calcs)
- LP interest assignment (and other changes) after the closing
- 10% test for Carryover Allocation:
 - What it is
 - Reasonably expected basis (denominator)
 - Eligible costs incurred (numerator)
 - Development fee recognition
 - Purchase notes
- Scattered sites
- LIHC eligible basis
- Coordination with SLIHC
- Coordination with NYS Brownfield Credits
- Property management including tenant income and rent compliance
- Tax exempt bond rules

Selected Tax Credit Issues

Presented by Jim DeBellis
Salmin Celona Wehrle & Flaherty, LLP

Acquisition Credit Issues

To qualify for acquisition credits an existing building must first meet the following four requirements:

- 1.) The building must be acquired by purchase as defined in IRS Code Sec 179(d)(2).
- 2.) Ten years must have passed before the building was last placed in service. There previously was a provision that ten years also have had to pass since the last nonqualified substantial improvements of the building, but this provision was eliminated by the Housing Assistance Tax Act of 2008 (hereafter referred to as HATA2008).
- 3.) The building must not have been previously placed in service by the purchaser or a related party with respect to the purchaser.
- 4.) Substantial rehabilitation costs are incurred.

Prior to the HATA2008, a person is considered related to the purchaser if the relationship between such person and the purchaser is one contained in Code Sec 267(b) or 707(b)(1) and by substituting 10% for 50%. For example, in determining whether a person and/or partnership is related to a partnership, a 10% ownership in either the capital or profits interest of two separate partnerships by the same partner would cause the two partnerships to be related. For example, assume Partner P owned more than a 10 interest in Partnership A. New Partnership B is formed to purchase the building of Partnership A with the objective of rehabilitating it to obtain Low Income Housing Tax credits. Partner P's ownership interest in the capital or profits in New Partnership B can not exceed 10%.

HATA2008 amended this provision by changing the ownership percentage used to determine the related party test to 50%.

Prior to the HATA2008, the 10-year requirement noted in item "2" above could be waived by the IRS for certain federally assisted distressed projects. Generally a waiver could be granted if Federal mortgage funds were at risk for a specific project, for certain mortgage prepayment properties and for certain properties owned by certain defaulting institutions. To obtain the waiver required a private letter ruling from the IRS which could be both time consuming and costly. HATA2008 now provides for an automatic waiver of the 10-year hold requirement for any federally or state assisted building. For purposes of this exception, a federally assisted building is any building which is substantially assisted, financed, or operated under Section 8 of the United States Housing Act of 1937, Section 221(d)(3), 221 (d)(4), or 236 of the National Housing Act, Section 515 of the Housing Act of 1949, or any other housing program administered by the Department of Housing and Urban Development or by Rural Housing Service of the Department of Agriculture. A state-assisted building is any building which is

substantially assisted, finance or operated under any state law with purposes similar to those of the federal laws referred to in the definition of federally assisted building.

The existing exception to the 10-year holding period requirement for buildings acquired from an insured depository institution in default is retained.

Acquisition/Rehab First Year Credit Issues

Computation of the low income housing tax credit is based on the “Applicable Fraction” using the lower of the unit fraction or the floor space fraction. The unit fraction is computed where the numerator is the number of units containing qualified low income tenants and the denominator is the number of total units in the building. The floor space fraction is computed where the numerator is the total floor space of units containing qualified low income tenants and the denominator is the total floor space of all units in the building. To qualify as a low income unit, the unit must both be rent restricted and occupied by a tenant who satisfies the income limitations under the elected set aside test.

Computation of the applicable percentage for the first year of a credit period must be prorated on a monthly basis. A unit is considered to contain a qualified low income tenant if the unit is occupied on the last day of the month. Only units in service for a full month during the first credit year qualify for use in the numerator.

Only one applicable fraction need be computed for both the acquisition credit and the rehab credit. If the rehab is completed in the same year of the building acquisition, the applicable percentage will start with the first full month the building was in service. If the rehab is placed in service in the year following the acquisition, the applicable fraction will start with January 1 of the year the rehab is placed in service. In this scenario, no credits will be allowed in the year of acquisition.

Tenants must go through an income certification process to qualify a unit as a low income unit in order for that unit to be eligible for tax credits. For an acquisition/rehab project, if existing tenants are certified within 120 days of the acquisition date, the effective date of the certification is the acquisition date. Income limits as in effect on the acquisition date are used in the certification process. This allows for a greater applicable fraction as months prior to the actual certification date can be used in the numerator. Note that “verification” of tenant income can begin up to 120 days “prior” to the acquisition date. However, the certification must be dated after the acquisition date.

Existing tenants certified after the 120 day window are treated as new move ins and thus would lose the possible additional four months of qualified occupancy in the applicable fraction computation had they been certified within the 120 day period from the date of acquisition.

Per the final Form 8823 Guide, the following units are considered low-income units in the first credit year for purposes of computing the applicable fraction:

- 1.) Units initially occupied and certified after the beginning of the credit period regardless of whether rehab costs have been incurred for the unit.
- 2.) Units occupied by income qualified households that moved from other units within the project
- 3.) Vacant units that were suitable for occupancy and previously occupied by income-qualified households.
- 4.) Units occupied and certified before the beginning of the credit period but are now over the income limits at the beginning of the credit period and the household was “tested” for the Available Unit Rule. (Rev Proc 2003-82) This “test” consist of confirming with the household that sources and amounts of anticipated income included on the tenant income certification are still current. If additional sources or amounts of income are identified the tenant income certification will be updated. It is not be necessary to obtain third party verifications for purposes of this rule.

Per the final Form 8823 Guide, the following units are not considered low-income units in the first credit year for purposes of computing the applicable fraction:

- 1.) The unit is occupied by a nonqualified household;
- 2.) The unit is vacant and was last occupied by a nonqualified household;
- 3.) The unit is not suitable for occupancy. These units, including units being rehabilitated, are considered “out of compliance”. The noncompliance is corrected when the unit is again suitable for occupancy. The unit’s character will be determined based on the household that occupied the unit immediately preceding the rehabilitation during the first year of the current period.

SEE EXAMPLE IN POWERPOINT PRESENTATION!

Effect of Federal Grants and Below Market Interest Federal Loans.

Grants – Under prior law, eligible basis is reduced by certain federal grants. Specifically, if during any tax year of a building’s compliance period, a grant that is funded with federal funds is made with respect to a building or its “operations”, the eligible basis of the building for that tax year and all succeeding tax years is reduced by the portion of the grant that is federally funded.

Example of grants that may not be included in eligible basis include Community Development Block Grants, Urban Development Action Grants, Rental Rehabilitation Grants, Historic Tax Credits and Housing Development Grants.

The HATA2008 clarifies that only cost of buildings financed with the proceeds of a federally funded grant reduces eligible basis. Rental Assistance payments and IRP payments do not constitute federal grants for purposes of the basis reduction rules. Also it appears that any other types of federal grants used for “operations” such as to “train staff” would no longer result in basis reduction.

Below Market Interest Federal Loans – Under prior law, a new building that received a federal subsidy was not eligible for the 9% credit. A federal subsidy is any tax exempt bond financing or a direct or indirect federal loan if the interest rate is below the applicable federal rate “AFR”. Taxpayers could avoid the federal subsidy taint and claim the 9% credit if they elected to exclude the federal subsidy from eligible basis.

Under the HATA2008, below market federal loans are no longer treated as a federal subsidy for purposes of determining whether a new building or substantial rehabilitations to an existing building are eligible for the 9% low-income housing credit rate. Accordingly, a new building or substantial rehabilitations to an existing building are considered federally subsidized only if financed by tax-exempt bonds.

CHW

Cannon Heyman & Weiss, LLP

Law Practice Concentrating in Affordable Housing and Community Development Law

**Tax Exempt Not-For-Profit Participation in
LIHTC Transactions and Other Miscellaneous LIHTC Issues**
NYSFAFH Upstate NY Affordable Housing Conference, September 23, 2008
Tim Favaro, Cannon Heyman & Weiss, LLP

I. Background (5 Min)

- (1) Prior to 1980, the IRS generally frowned upon the idea of an entity exempt from taxation under Section 501(a) and 501(c)(3) of the Code participating as a general partner in a for-profit limited partnership because of the inherent conflict between the obligation of the exempt entity to further its exempt purpose and the profit motive of the partnership.
- (2) *Plumstead Theatre Society, Inc. v. Commissioner* (1980) – Tax Court Case which held that participation of tax a exempt entity as a general partner in a for-profit limited partnership did not violate the obligation of the tax exempt entity to operate exclusively for charitable purposes, and that the tax exempt entity was not operating for the benefit of private, rather than public interests.
- (3) In *General Counsel Memorandum 39005* (1983), the IRS distilled a two prong test to determine whether an entity will qualify as tax exempt even though it participates as a general partner in a for-profit limited partnership:
 - Prong #1 - Does the exempt organization's participation in the limited partnership further its exempt purpose?; and
 - Prong #2 - Does the limited partnership arrangement permit the exempt organization to act exclusively in furtherance of its exempt purposes, rather than for the benefit of the for-profit partner?
- (4) In *Revenue Procedure 96-32* (1996) (**See Exhibit A Attached**) the IRS provided for a safe harbor under which organizations providing low-income housing will be deemed charitable. By complying with the safe harbor test, a tax exempt entity will meet the first prong of the test, however, there was no solid guidance as to how to meet the second prong of the test that resulted in the IRS requiring that a final Partnership Agreement be submitted with the 1023 application for exemption.

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II. Joseph Urban (2006) and Robert S. Choi (2007) Internal Memoranda (See Exhibit B Attached) (5 Min)

- (1)** April 25, 2006 IRS internal memorandum ("the Urban Memo") outlined the rules the IRS would apply when reviewing an exemption application for a not-for-profit entity that will serve as a general partner in a tax credit limited partnership.
- (2)** July 30, 2007 IRS internal memorandum (the "Choi Memo") supersedes the Urban Memo above and varies only slightly it to clarify that applicants (i) should identify a specific proposed housing project to be operated by the limited partnership, and (ii) that a final executed partnership agreement need **not** be submitted to the IRS as required by the Urban Memo. However, the Choi Memo also indicates that items 1-4 in the memorandum **must** be met for the Choi Memo to apply and that failure to meet a particular factor listed in item 5 will not adversely affect the application if the applicant can describe how it will otherwise address the concern of that particular factor.
- (3)** These memoranda provide guidance as to what actions must be taken, what representations must be made by an applicant and the nature of provisions the IRS wants to see in partnership agreements to substantiate Prong #2 of the test described above.
- (4)** The memoranda require, among other things, that:
 - a.** the applicant provide a written representation that the partnership agreement will provide a statement that if there is a conflict between charitable purposes and maximizing the profits of limited partners, the charitable purposes will prevail;
 - b.** operating deficit guarantees must be limited either in duration (five years from achievement of breakeven operations) or in amount (six months of operating expenses);
 - c.** payments under each separate tax credit adjuster provision be limited to an amount equal to the developer fee or other fees the applicant will receive;
 - d.** in the event that the applicant would be required to repurchase a limited partner's interest, the purchase price may not exceed the amount of capital contributions of the limited partner;
 - e.** the partnership agreement provide for the reasonable consent of the limited partner to certain actions of the applicant, as general partner, as opposed to consent in the limited partner's sole discretion.
- (5)** To the extent that either the partnership agreement or the business deal do not adhere to these factors, such factors will be considered when determining whether the tax exempt entity is inappropriately benefiting private interests thereby jeopardizing its tax exempt status.

III. What is the IRC Section 168(h)(6)(F) Election? (See Exhibit C Attached for Selected Excerpts) (5 Min)

- (1) Generally, under Section 168(h)(6)(A), property that is owned by a partnership with both a tax exempt partner and a non-tax exempt partner will be deemed to be "tax exempt use property" to the extent of the tax exempt entity's proportionate share of such property and to the extent that allocations to the tax exempt entity are not "qualified allocations".
- (2) Tax-exempt controlled entities are treated as tax exempt entities. A tax exempt controlled entity is any corporation in which 50% or more of the value of stock of the corporation is held by one or more tax exempt entities.
- (3) The consequences of a tax exempt use property designation include, among others, (a) the portion of the property that is tax exempt use property must use the alternative depreciation system under Section 168(g) which requires 40 year depreciation and (b) under IRC Section 47(c)(2)(B)(v) any expenditure allocated to tax exempt use property will not be deemed to be a qualified rehabilitation expenditure for purposes of calculating rehabilitation (a.k.a. Historic) tax credits.
- (4) Avoid the tax exempt use property designation by using a for-profit subsidiary of the sponsoring tax exempt entity as the general partner and make a Section 168(h)(6)(f) election available to tax-exempt controlled corporations so that such subsidiary will not be treated as a tax exempt controlled entity and such subsidiary's proportionate share of the property is therefore not deemed to be tax exempt use property, however, any gain or dividend recognized by such tax exempt entity attributable to such subsidiary will be deemed to be unrelated business taxable income. Note, limited liability company or partnership subsidiaries must first elect to be taxed as a corporation in order to make the Section 168(h)(6)(f) election.
- (5) The Section 168(h)(6)(F) Election must be made by the due date (including extensions) of the tax return for the first taxable year for which the election is to be effective. **(See Exhibit D Attached)**

IV. Issues Combining Rehabilitation Tax Credits under Section 47 of the IRC with LIHTC, Eligible Basis Reduction (See Exhibit E Attached for Sample Structure Chart) (5 Min)

- (1) **The Problem.** Generally, owners of Certified Historic Structures that undergo a substantial rehabilitation are eligible for rehabilitation tax credits equal to 20% of the qualified rehabilitation expenditures incurred by the owner, however, LIHTC project must reduce eligible basis by the amount of rehabilitation credits claimed under the following legal analysis:

- a. IRC Section 42(d)(1) provides that the eligible basis of a new building for purposes of LIHTC is its adjusted basis as of the close of the first taxable year of the credit period.
 - b. IRC Section 1016 defines "adjusted basis" of property and provides that there shall be an adjustment to the extent provided in IRC Section 50(c), in the case of expenditures with respect to which a credit has been allowed under Section 38.
 - c. IRC Section 50(c) provides that if a credit is allowed with respect to a property, the basis of such property must be reduced by the amount of credit so determined.
 - d. Although the rules for the rehabilitation credit are described in IRC Section 47, the credit is allowed under IRC Section 38. Therefore, to the extent rehabilitation credits are generated by a building that will also generate LIHTC, eligible basis must be reduced by the amount of rehabilitation tax credits.
- (2) The Solution.** Generally, the IRC allows the owner of a building to enter into a lease of such building with a lessee and treat the lessee as if it had incurred the qualified rehabilitation expenditures, and since the lessee is not treated as the owner of the property, no basis adjustment under IRC Section 50(c) can be made under the following legal analysis:
- a. IRC Section 50(d) allows the owner to enter into a lease of such building with a lessee and to treat the lessee as if it had incurred the qualified rehabilitation expenditures of the lessor/owner.
 - b. IRC Section 48(d)(5) (made applicable under IRC 50(d)) provides that when rehabilitation credits are passed-through to a lessee a basis adjustment is not required.
 - c. IRC Section 48(d)(5) (B) provides that when rehabilitation credits are passed-through to a lessee, the lessee shall include ratably in gross income over the shortest recovery period applicable under IRC Section 168, an amount equal to the credit allowable to the lessee under IRC Section 38.
 - d. Therefore, the IRS is made whole because the economic equivalent of the depreciation that the IRC would have otherwise disallowed by reason of the reduction in basis of the property is being received through this requirement.

V. Miscellaneous Not For Profit Issues in LIHTC Transactions (Time Permitting)

EXHIBIT A

Revenue Procedure 96-32

Rev. Proc. 96-32, 1996-1 C.B. 717, 1996-20 I.R.B. 14.

INTERNAL REVENUE SERVICE Revenue Procedure

LOW-INCOME HOUSING GUIDELINES

Released: May 1, 1996
Published: May 13, 1996

26 CFR 601.201: Rulings and determination letters.

Low-income housing guidelines. Guidance on qualification for tax-exemption under section 501(c)(3) is provided for organizations that provide low-income housing. The guidance includes a safe-harbor procedure to determine qualification.

SECTION 1. PURPOSE

.01 This revenue procedure sets forth a safe harbor under which organizations that provide low-income housing will be considered charitable as described in § 501(c)(3) of the Internal Revenue Code because they relieve the poor and distressed as described in § 1.501(c)(3)-1(d)(2) of the Income Tax Regulations. This revenue procedure also describes the facts and circumstances test that will apply to determine whether organizations that fall outside the safe harbor relieve the poor and distressed such that they will be considered charitable organizations described in § 501(c)(3). It also clarifies that housing organizations may rely on other charitable purposes to qualify for recognition of exemption from federal income tax as organizations described in § 501(c)(3). These other charitable purposes are described in § 1.501(c)(3)-1(d)(2). This revenue procedure supersedes the application referral described in Notice 93-1, 1993-1 C.B. 290.

.02 This revenue procedure does not alter the standards that have long been applied to determine whether low-income housing organizations qualify for tax-exempt status under § 501(c)(3). Rather, it is intended to expedite the consideration of applications for tax-exempt status filed by such organizations by providing a safe harbor and by accumulating relevant information on the existing standards for exemption in a single document. Low-income housing organizations that have ruling or determination letters and have not materially changed their organizations or operations from how they were described in their applications can continue to rely on those letters.

SEC. 2. BACKGROUND OF SAFE HARBOR

.01 Rev. Rul. 67-138, 1967-1 C.B. 129, Rev. Rul. 70-585, 1970-2 C.B. 115, and Rev. Rul. 76-408, 1976-2 C.B. 145, hold that the provision of housing for low-income persons accomplishes charitable purposes by relieving the poor and distressed. The Service has long held that poor and distressed beneficiaries must be needy in the sense that they cannot afford the necessities of life. Rev. Ruls. 67-138, 70-585, and 76-408 refer to the needs of housing recipients and to their inability to secure adequate housing under all the facts and circumstances to determine whether they are poor and distressed.

.02 The existence of a national housing policy to maintain a commitment to provide decent, safe, and sanitary housing for every American family is reflected in several federal housing acts. See, for example, § 2 of the United States Housing Act of 1937, 42 U.S.C. § 1437; § 2 of the Housing Act of 1949, 42 U.S.C. § 1441; § 2 of the Housing and Urban Development Act of 1968, 12 U.S.C. § 1701t; and §§ 101, 102, and 202 of the Cranston-Gonzalez National Affordable Housing Act, 42 U.S.C. §§ 12701, 12702, and 12721. Not all beneficiaries of these housing acts, however, are necessarily poor and distressed within the meaning of § 1.501(c)(3)-1(d)(2).

.03 In order to support national housing policy, the safe harbor contained in this revenue procedure identifies those low-income housing organizations that will, with certainty, be considered to relieve the poor and distressed. The safe harbor permits a limited number of units occupied by residents with

incomes above the low-income limits in order to assist in the social and economic integration of the poorer residents and, thereby, further the organization's charitable purposes. To avoid giving undue assistance to those who can otherwise afford safe, decent, and sanitary housing, the safe harbor requires occupancy by significant levels of both very low-income and low-income families.

.04 Low-income housing organizations that fall outside the safe harbor may still be considered organizations that offer relief to the poor and distressed based on all the surrounding facts and circumstances. Some of the facts and circumstances that will be taken into consideration in determining whether a low-income housing organization will be so considered are set forth in section 4.

.05 Low-income housing organizations may also qualify for tax-exempt status because they serve a charitable purpose described in § 501(c)(3) other than relief of the poor and distressed. Exempt purposes other than relief of the poor and distressed are discussed in section 6.

.06 To be recognized as exempt from income tax under § 501(c)(3), a low-income housing organization must not only serve a charitable purpose but also meet the other requirements of that section, including the prohibitions against inurement and private benefit. Specific concerns with respect to these prohibitions are set forth in section 7.

SEC. 3. SAFE HARBOR FOR RELIEVING THE POOR AND DISTRESSED

.01 An organization will be considered charitable as described in § 501(c)(3) if it satisfies the following requirements:

(1) The organization establishes for each project that (a) at least 75 percent of the units are occupied by residents that qualify as low-income; and (b) either at least 20 percent of the units are occupied by residents that also meet the very low-income limit for the area or 40 percent of the units are occupied by residents that also do not exceed 120 percent of the area's very low-income limit. Up to 25 percent of the units may be provided at market rates to persons who have incomes in excess of the low-income limit.

(2) The project is actually occupied by poor and distressed residents. For projects requiring construction or rehabilitation, a reasonable transition period is allowed for an organization to place the project in service. Whether an organization's transition period is reasonable is determined by reference to all relevant facts and circumstances. For projects that do not require substantial construction or substantial rehabilitation, a one-year transition period to satisfy the actual occupancy requirement will generally be considered to be reasonable. If a project operates under a government program that allows a longer transition period, this longer period will be used to determine reasonableness.

(3) The housing is affordable to the charitable beneficiaries. In the case of rental housing, this requirement will ordinarily be satisfied by the adoption of a rental policy that complies with government-imposed rental restrictions or otherwise provides for the limitation of the tenant's portion of the rent charged to ensure that the housing is affordable to low-income and very low-income residents. In the case of homeownership programs, this requirement will ordinarily be satisfied by the adoption of a mortgage policy that complies with government-imposed mortgage limitations or otherwise makes the initial and continuing costs of purchasing a home affordable to low and very low-income residents.

(4) If a project consists of multiple buildings and each building does not separately meet the requirements of sections 3.01(1), (2), and (3), then the buildings must share the same grounds. This requirement does not apply to organizations that provide individual homes or individual apartment units located at scattered sites in the community exclusively to families with incomes at or below 80 percent of the area's median income.

.02 In applying this safe harbor, the Service will follow the provisions listed below:

(1) Low-income families and very low-income families will be identified in accordance with the income limits computed and published by the Department of Housing and Urban Development ("HUD") in Income Limits for Low and Very Low-Income Families Under the Housing Act of 1937. The term "very low-

income" is defined by the relevant housing statute as 50 percent of an area's median income. The term "low-income" is defined by the same statute as 80 percent of an area's median income. However, these income limits may be adjusted by HUD to reflect economic differences, such as high housing costs, in each area. The income limits are then tailored to reflect different family sizes. If HUD's program terminates, the Service will use income limits computed under such program as is in effect immediately before such termination. Copies of all or part of HUD's publication may be obtained by calling HUD at (800) 245-2691 (HUD charges a small fee to cover costs of reproduction).

(2) The retention of the right to evict tenants for failure to pay rent or other misconduct, or the right to foreclose on homeowners for defaulting on loans will not, in and of itself, cause the organization to fail to meet the safe harbor.

(3) An organization originally meeting the safe harbor will continue to satisfy the requirements of the safe harbor if a resident's income increases and causes the organization to fail the safe harbor, provided that the resident's income does not exceed 140 percent of the applicable income limit under the safe harbor. If the resident's income exceeds 140 percent of the qualifying income limit, the organization will not fail to meet the safe harbor if it rents the next comparable non-qualifying unit to someone under the income limits.

(4) To be considered charitable, an organization that provides assistance to the aged or physically handicapped who are not poor must satisfy the requirements set forth in Rev. Rul. 72124, 1972-1 C.B. 145, Rev. Rul. 79-18, 1979-1 C.B. 194, and Rev. Rul. 79-19, 1979-1 C.B. 195. If an organization meets the safe harbor, then it does not need to meet the requirements of these rulings even if all of its residents are elderly or handicapped residents. However, an organization may not use a combination of elderly or handicapped persons and low-income persons to establish the 75-percent occupancy requirement of the safe harbor. An organization with a mix of elderly or handicapped residents and low-income residents may still qualify for tax-exempt status under the facts and circumstances test set forth in section 4.

SEC. 4. FACTS AND CIRCUMSTANCES TEST FOR RELIEVING THE POOR AND DISTRESSED

.01 If the safe harbor contained in section 3 is not satisfied, an organization may demonstrate that it relieves the poor and distressed by reference to all the surrounding facts and circumstances.

.02 Facts and circumstances that demonstrate relief of the poor may include, but are not limited to, the following:

(1) A substantially greater percentage of residents than required by the safe harbor with incomes up to 120 percent of the area's very low-income limit.

(2) Limited degree of deviation from the safe harbor percentages.

(3) Limitation of a resident's portion of rent or mortgage payment to ensure that the housing is affordable to low-income and very low-income residents.

(4) Participation in a government housing program designed to provide affordable housing.

(5) Operation through a community-based board of directors, particularly if the selection process demonstrates that community groups have input into the organization's operations.

(6) The provision of additional social services affordable to the poor residents.

(7) Relationship with an existing 501(c)(3) organization active in low-income housing for at least five years if the existing organization demonstrates control.

(8) Acceptance of residents who, when considered individually, have unusual burdens such as extremely high medical costs which cause them to be in a condition similar to persons within the qualifying income limits in spite of their higher incomes.

(9) Participation in a homeownership program designed to provide homeownership opportunities for families that cannot otherwise afford to purchase safe and decent housing.

(10) Existence of affordability covenants or restrictions running with the property.

SEC. 5. EXAMPLES

.01 Application of the safe harbor and the facts and circumstances test is illustrated by the following examples:

(1) Organization N operates pursuant to a government program to provide low and moderate income housing projects. Seventy percent of N's residents have incomes that do not exceed the area's low-income limit. Fifty percent of N's residents have incomes that are at or below the area's very low-income limit. Under the program, N restricts rents charged to residents below the income limits to no more than 30 percent of the applicable low or very low-income limits for N's area. N is close to meeting the safe harbor. N has a substantially greater percentage of very low-income residents than required by the safe harbor; it participates in a federal housing program; and it restricts its rents pursuant to an established government program. Although N does not meet the safe harbor, the facts and circumstances demonstrate that N relieves the poor and distressed.

(2) Organization O will finance a housing project using tax-exempt bonds pursuant to § 145(d). O will meet the 20-50 test under § 142(d)(1)(A). Another 45 percent of the residents will have incomes at or below 80 percent of the area's median income. The final 35 percent of the residents will have incomes above 80 percent of the area's median income. O will restrict rents charged to residents below the income limits to no more than 30 percent of the residents' incomes. O will provide social services to project residents and to other low-income residents in the neighborhood. Also, O will purchase its project through a government program designed to retain low-income housing stock. O does not meet the safe harbor. However, the facts and circumstances demonstrate that O relieves the poor and distressed.

(3) Organization R provides affordable homeownership opportunities to purchasers determined to be low-income under a federal housing program. The homes are scattered throughout a section of R's community. Beneficiaries under the program cannot afford to purchase housing without assistance. R's program makes the initial and continuing costs of mortgages affordable to the home buyers by providing assistance with down payments and closing costs. Homeowners assisted by R will have the following composition: 40 percent will not exceed 140 percent of the very low-income limit for the area, 25 percent will not exceed the low-income limit, and 35 percent will exceed the low-income limit but will not exceed 115 percent of the area's median income. R does not satisfy the safe harbor. However, the facts and circumstances demonstrate that R relieves the poor and distressed.

(4) Organization U will purchase existing residential rental housing financed using tax-exempt bonds issued in accordance with § 145(d). U will meet the minimum requirements of the 40-60 test of § 142(d)(1)(B). It will provide the balance of its units to residents with incomes at or above area median income levels. U has a community-based board of directors. U does not satisfy the safe harbor. Moreover, the facts and circumstances do not demonstrate that U relieves the poor and distressed.

(5) Organization V provides rental housing in a section of the city where income levels are well below the other parts of the city. All of V's residents are below the very low-income limits for the area, yet they pay rents that are above 50 percent of the area's very low-income limits. V has not otherwise demonstrated that the housing is affordable to its residents. Although the residents are all considered poor and distressed under the safe harbor, V does not relieve the poverty of the residents.

(6) Organization W provides homeownership opportunities to purchasers with incomes up to 115 percent of the area's median income. W does not meet the income levels required under the safe harbor. W's board of directors is representative of community interests, and W provides classes and counseling services for its residents. The facts and circumstances do not demonstrate that W relieves the poor and distressed.

SEC. 6. EXEMPT PURPOSES OTHER THAN RELIEVING THE POOR AND DISTRESSED

.01 Relief of the poor and distressed, whether demonstrated by satisfaction of the safe harbor described in section 3 of this Revenue Procedure or by reference to the facts and circumstances test described in section 4, does not constitute the only exempt purpose that a housing organization may have. Such organizations may qualify for exemption without having to satisfy the standards for relief of the poor and distressed by providing housing in a way that accomplishes any of the purposes set forth in § 501(c)(3) or § 1.501(c)(3)-1(d)(2). Those purposes include, but are not limited to, the following:

(1) Combatting community deterioration is an exempt purpose, as illustrated by Rev. Rul. 68-17, 1968-1 C.B. 247, Rev. Rul. 68-655, 1968-2 C.B. 213, Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 3), and Rev. Rul. 76-147, 1976-1 C.B. 151. An organization that combats community deterioration must (1) operate in an area with actual or potential deterioration, and (2) directly prevent or relieve that deterioration. Constructing or rehabilitating housing has the potential to combat community deterioration.

(2) Lessening the burdens of government is an exempt purpose, as illustrated by Rev. Ruls. 85-1 and 85-2, 1985-1 C.B. 178. An organization lessens the burdens of government if (a) there is an objective manifestation by the governmental unit that it considers the activities of the organization to be the government's burdens, and (b) the organization actually lessens the government's burdens.

(3) Elimination of discrimination and prejudice is an exempt purpose, as illustrated by Rev. Rul. 68-655, 1968-2 C.B. 213, and Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 2). These rulings describe organizations that further charitable purposes by assisting persons in specific racial groups to acquire housing for the purpose of stabilizing neighborhoods or reducing racial imbalances.

(4) Lessening neighborhood tensions is an exempt purpose, as illustrated by Rev. Rul. 68-655, 1968-2 C.B. 213, and Rev. Rul. 70-585, 1970-2 C.B. 115 (Situation 2). It is generally identified as an additional charitable purpose by organizations that fight poverty and community deterioration associated with overcrowding in lower income areas in which ethnic or racial tensions are high.

(5) Relief of the distress of the elderly or physically handicapped is an exempt purpose, as illustrated by Rev. Rul. 72-124, 1972-1 C.B. 145, Rev. Rul. 79-18, 1979-1 C.B. 194, and Rev. Rul. 79-19, 1979-1 C.B. 195. An organization may further a charitable purpose by meeting the special needs of the elderly or physically handicapped.

SEC. 7. OTHER CONSIDERATIONS

If an organization furthers a charitable purpose such as relieving the poor and distressed, it nevertheless may fail to qualify for exemption because private interests of individuals with a financial stake in the project are furthered. For example, the role of a private developer or management company in the organization's activities must be carefully scrutinized to ensure the absence of inurement or impermissible private benefit resulting from real property sales, development fees, or management contracts.

SEC. 8. EFFECT ON OTHER DOCUMENTS

Notice 93-1 is superseded.

SEC. 9. EFFECTIVE DATE

This revenue procedure is effective on [date of publication].

DRAFTING INFORMATION

The principal authors of this revenue procedure are Lynn Kawecky and Marvin Friedlander. For further information regarding this revenue procedure, contact Mr. Kawecky at (202) 622-7305 (not a toll free number).

EXHIBIT B

ROBERT S. CHOI IRS INTERNAL MEMO



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

July 30, 2007

MEMORANDUM FOR MANAGER, EO DETERMINATIONS

FROM: Robert S. Choi
Director, EO Rulings and Agreements

SUBJECT: Low Income Housing Tax Credit Limited Partnerships

This memorandum supersedes the Memorandum entitled "Low Income Housing Tax Credit Limited Partnerships" dated April 25, 2006. The original memorandum provided a framework to permit the Internal Revenue Service to approve an exemption application submitted by a general partner before the partnership agreement was finalized. This memorandum clarifies the April 25, 2006 memorandum to require that the applicant identify a specific proposed housing project to be operated by the limited partnership and deletes the request that a copy of a final limited partnership agreement be provided upon execution.

The purpose of this memorandum is to provide a framework 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. An organization must meet items 1 through 4 to have this memorandum apply. Failure to meet a particular factor listed in item 5 may not adversely affect an application where the applicant can otherwise describe how it will satisfy the particular concern described in the factor. Application of this framework assumes that an organization otherwise qualifies for exemption.

1. The applicant must identify the specific proposed housing project to be operated by the limited partnership and 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 set forth in item 3 below are required.

Low Income Housing Tax Credit Limited Partnerships

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).
 - 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 factors, 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

Low Income Housing Tax Credit Limited Partnerships

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
 - (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

Low Income Housing Tax Credit Limited Partnerships

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 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.

EXHIBIT C

IRC SECTION 168(h)(6) Excerpt

Selected Provisions from
Internal Revenue Code Section 168(h)(6)

- (6) Treatment of property owned by partnerships, etc.
- (A) In general. For purposes of this subsection, if--
- (i) any property which (but for this subparagraph) is not tax-exempt use property, is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, and
 - (ii) any allocation to the tax-exempt entity of partnership items is not a qualified allocation,
- an amount equal to such tax-exempt entity's proportionate share of such property shall (except as provided in paragraph (d)(D)) be treated as tax-exempt use property.
- (B) Qualified allocation. For purposes of subparagraph (A), the term "qualified allocation" means any allocation to a tax-exempt entity which--
- (i) is consistent with such entity's being allocated the same distributive share of each item of income, gain, loss, deduction, credit, and basis and such share remains the same during the entire period the entity is a partner in the partnership, and
 - (ii) has substantial economic effect within the meaning of section 704(b)(2) [26 USCS § 704(b)(2)].
- For purposes of this subparagraph, items allocated under section 704(c) [26 USCS § 704(c)] shall not be taken into account.
- (C) Determination of proportionate share.
- (i) In general. For purposes of subparagraph (A), a tax-exempt entity's proportionate share of any property owned by a partnership shall be determined on the basis of such entity's share of partnership items of income or gain (excluding gain allocated under section 704(c) [26 USCS § 704(c)]), whichever results in the largest proportionate share.
 - (ii) Determination where allocations vary. For purposes of clause (i), if a tax-exempt entity's share of partnership items of income or gain (excluding gain allocated under section 704(c) [26 USCS § 704(c)]) may vary during the period such entity is a partner in the partnership, such share shall be the highest share such entity may receive.
- (D) Determination of whether property used in unrelated trade or business. For purposes of this subsection, in the case of any property which is owned by a partnership which has both a tax-exempt entity and a person who is not a tax-exempt entity as partners, the determination of whether such property is used in an unrelated trade or business of such an entity shall be made without regard to section 514 [26 USCS § 514].
- (E) Other pass-thru entities; tiered entities. Rules similar to the rules of subparagraphs (A), (B), (C), and (D) shall also apply in the case of any pass-thru entity other than a partnership and in the case of tiered partnerships and other entities.
- (6) Treatment of certain taxable entities.
- (i) In general. For purposes of this paragraph and paragraph (c), except as otherwise provided in this subparagraph, any tax-exempt controlled entity shall be treated as a tax-exempt entity.
- (ii) Election. If a tax-exempt controlled entity makes an election under this clause--
- (I) such entity shall not be treated as a tax-exempt entity for purposes of this paragraph and paragraph (c), and
 - (II) any gain recognized by a tax-exempt entity on any disposition of an interest in such entity (and any dividend or interest received or accrued by a tax-exempt entity from such tax-exempt controlled entity) shall be treated as unrelated business taxable income for purposes of section 514 [26 USCS § 514].
- Any such election shall be irrevocable and shall bind all tax-exempt entities holding interests in such tax-exempt controlled entity. For purposes of subclause (II), there shall only be taken into account dividends which are properly allocable to income of the tax-exempt controlled entity which was not subject to tax under this chapter [26 USCS § § 1 et seq.].
- (iii) Tax-exempt controlled entity.
- (I) In general. The term "tax-exempt controlled entity" means any corporation (which is not a tax-exempt entity determined without regard to this subparagraph and paragraph (2)(E)) if 50 percent or more (in value) of the stock in such corporation is held by one or more tax-exempt entities (other than a foreign person or entity).
 - (II) Only 5-percent shareholders taken into account in case of publicly traded stock. For purposes of subclause (I), in the case of a corporation the stock of which is publicly traded on an established securities market, stock held by a tax-exempt entity shall not be taken into account unless such entity holds at least 5 percent (in value)

of the stock in such corporation. For purposes of this subclause, related entities (within the meaning of paragraph (4)) shall be treated as 1 entity.

(III) Section 318 to apply. For purposes of this clause, a tax-exempt entity shall be treated as holding stock which it holds through application of section 318 [26 USCS § 318] (determined without regard to the 50-percent limitation contained in subsection (a)(2)(C) thereof).

EXHIBIT D

SUMMARY OF WHEN AND HOW TO MAKE A IRC SECTION 168(h)(6)(f) ELECTION

MAKING THE 168(h)(6)(f)(ii) ELECTION

Temporary Treasury Regulation section 5h.5 sets forth the procedure for making an election under Code section 168(h)(6)(F)(ii). Pursuant to the Temporary Regulation, the election must be made by the due date (including any extensions) of the tax return for the first taxable year for which the election is to be effective.

The Temporary Regulations provide that the election is made by attaching a statement to the tax return for the taxable year in which the election is made. This election is made by the for-profit subsidiary which is the general partner in the limited partnership. Except as otherwise provided in the return or in the instructions accompanying the return for the taxable year, this statement should include the following:

- (A) the name, address, and taxpayer identification number of the electing taxpayer;
- (B) an identification of the election (indicating the section of the Code under which the election is made);
- (C) a description of the period for which the election is being made and/or the property to which the election is to apply; and
- (D) any additional information available to show the taxpayer is entitled to make the election.

Attached is a sample election statement. A copy of this election statement should also be attached to the nonprofit's federal tax returns (Forms 5500 and 990).

ELECTION FORM

[Name], general partner of [Partnership name]

E.I.N. of [GP].:

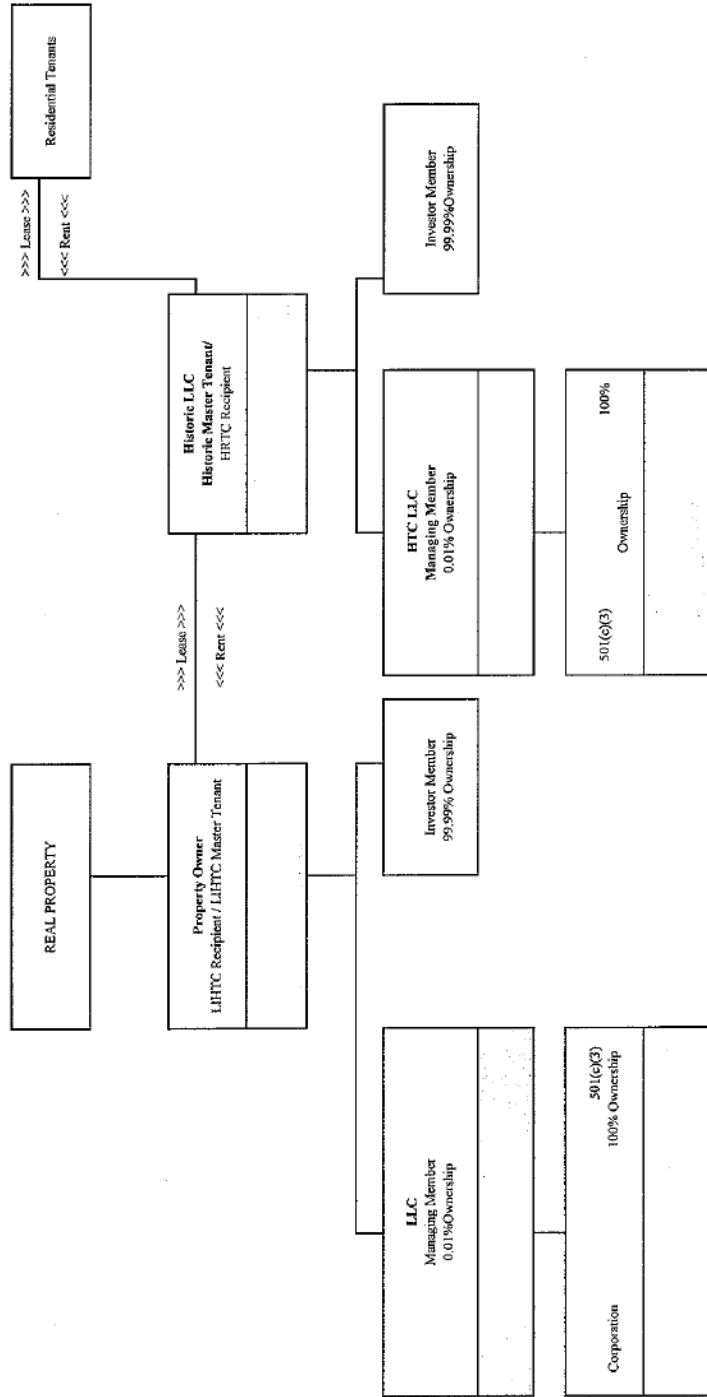
Form 4562; Depreciation and Amortization Election under Internal Revenue Code
Section 168(h)(6)(F)(ii)

Pursuant to Temporary Treasury Regulation sections 5h.5(a)(2) and (3)(i),
_____ [GP Name], a for-profit subsidiary of [Non-Profit Sponsor], a
_____ not-for-profit organization, hereby elects under Internal Revenue Code section
168(h)(6)(F)(ii): (i) not to be treated as a tax-exempt entity for purposes of Internal Revenue
Code sections 168(h)(5) and (6), and (ii) to treat any gain recognized by its tax-exempt parent on
any disposition of an interest in it (and to treat any dividends or interest received or accrued by
its tax-exempt parent from it) as unrelated business taxable income under Code section 511.

EXHIBIT E

**SAMPLE STRUCTURE CHART FOR
LIHTC/ HTC COMBINED TRANSACTION**

HTC / LIHTC Sample Structure Chart



SELECTED PARTNERSHIP TAX ISSUES
5TH ANNUAL UPSTATE AFFORDABLE HOUSING CONFERENCE

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September 23, 2008

SELECTED PARTNERSHIP TAX ISSUES

5TH ANNUAL UPSTATE NEW YORK AFFORDABLE HOUSING CONFERENCE

I. Partnership allocations – in general.

In general, partners are permitted to allocate income and loss in accordance with their economic arrangement. Since different partners may bring different assets (e.g. services, intangible property rights, a trade or business that is in need of a cash infusion, and of course cash) to the table, the partners are afforded flexibility in determining how the partnership's income and losses should be allocated. Flexibility creates an opportunity for abuse. That is, partners may allocate partnership items in a manner that reduces the partners' aggregate tax liabilities without significantly impacting their before tax cash flow from the partnership.

How could partners use their allocations to obtain a tax benefit?

character (capital vs. ordinary – for example, between a corporate and individual partner)

source (foreign vs. U.S. source – for example, between a U.S. partner and a foreign partner)

tax exempt vs. taxable

timing – for example, losses to taxpayer with expiring NOLs or capital loss carryforwards

built-in gain or loss

liabilities – to enable partners to deduct losses

other?

A system is therefore needed to restrict taxpayers' ability to use partnership allocations for tax avoidance purposes.

The problem – Orrisch vs. Commissioner (Tax Court 1970, 9th Circuit 1973)

Facts – Orrisch and Crisafis formed a partnership to purchase and rent apartment complexes in 1963. They allocated losses equally in 1963 through 1965. Orrisch was able to use the losses to offset other income, but Crisafis was not. The partners therefore agreed to allocate all depreciation to Orrisch for 1966 and future years, and to allocate gain to Orrisch to the extent of specially allocated depreciation. Critically,

however, the special allocation of depreciation did not affect the partners' sharing of cash flow upon a sale of the buildings. Since each partner was entitled to 50% of any cash flow from the sale of the building, the special allocation of depreciation and related gain to the Orrisch's did not effect the dollar amount of the partners shares of partnership income independent of tax consequences (i.e., apart from the tax benefit to Orrisch, both partners were entitled to the same cash flow from the partnership).

Note that if there was enough gain on the sale of the building to chargeback gain to Orrisch to the extent of the disproportionate depreciation allocation, the amount of net income allocated to each partner would have been equal to each partners' cash flow. Thus, it was possible that the allocations could work and it was too soon to tell that they did not. Why then did the court determine that the allocations were invalid? Because if the sale proceeds were insufficient to chargeback the entire gain, each party would still receive the same amount of cash. Thus, the allocations must have been made for tax avoidance purposes only.

The Tax Court therefore concluded that depreciation expense was required to be allocated equally to each partner.

II. The 704(b) regulations.

With so much opportunity for tax scheming, how could a system be devised to ensure allocations have true economic substance?

The regulations in effect at the time Orrisch was decided were brief, stating essentially that an allocation has substantial economic effect if the allocation may actually affect the dollar amount of the partners' share of partnership income or loss independent of tax consequences.

The 704(b) regulations were greatly expanded (about 1987) to add definition to the concept of substantial economic effect in order to give both the Service and taxpayers certainty that allocations will be respected if the regulatory provisions are followed. Thus, the allocations are generally considered a safe harbor.

Substantial economic effect is a two part test. The allocations must have:

- (i) economic effect, and
- (ii) the economic effect must be substantial.

This is an annual test. Thus, allocations may have substantial economic effect in one year but not another.

Economic effect, in general, means that the allocations follow the cash. Substantiality, in general, means that the allocations reflect the partners' business arrangement and are not purely for tax purposes. Substantiality is also

synonymous with *economic benefit*, in the case of profits, and *economic risk*, in the case of losses.

If the allocations in the agreement do not have substantial economic effect, the allocations must be allocated based on the partners' real interests in the partnership (or, in other words, based on allocations that do have substantial economic effect)

III. Economic effect.

This is an objective test.

The primary test – The big three

Capital account maintenance rules

Liquidation based on positive capital accounts

Deficit restoration obligations

These provisions ensure that the economic benefit or burden (e.g., cash) of an allocation is consistent with its tax consequences. In other words, if a partner receives an allocation of income, such partner will ultimately receive such income. The same should be true for an allocation of loss or deduction.

Capital account maintenance rules.

Maintenance of capital accounts is critical because the capital account represents the partners equity, and therefore rights to liquidation proceeds (similar to a share of stock in a corporation) in the partnership. There must therefore be symmetry between a partner's rights to cash flow and the income or loss allocated to the partner.

Capital is increased by:

money contributed by the partner

the FMV of property contributed (net of liabilities assumed by the partnership)

allocations of partnership income and gain (including tax exempt income)

Capital is decreased by:

(i) money distributed to the partner

(ii) the FMV of property distributed (net of liabilities assumed by the partner)

- (iii) allocations of partnership loss and deductions (including nondeductible expenditures)

The value at which property is recorded on the books of the partnership under the above rules is referred to as its “book value”. This is in reference to the rules of Section 704(b), and not the amount at which the property is recorded on the company’s books and records or in the company’s financial statements under GAAP. Once the property is recorded at its book value, the book value is generally not adjusted except for depreciation or amortization expense. Thus, increases or decreases in the FMV of the property, however real they may be, are not generally reflected in the book value of the property or the partners’ capital account. The property is therefore carried on its books at its “historical” book value.

The regulations further provide, for all purposes of evaluating the allocations under the safe harbor, that the value of the partnership’s property is equal to its book value. This is referred to as the “value equals basis” rule.

The partners can, however, if they so elect, restate their capital accounts (and the book value of property) to reflect the current FMV of the partnership’s property upon certain events (where an arm’s length determination of the current value of the partnership’s property can be determined; e.g., the receipt or redemption of an interest in the partnership). This is referred to as a “book up” provision. This is optional but must be in the partnership agreement to be followed.

IV. Liabilities – the basics.

Partnership liabilities are treated as liabilities of the partners for purposes of computing the basis of the partners’ interests in the partnership. Partnership liabilities are allocated among the partners based on the guidance provided in Section 752.

Under Section 752(a), an increase in a partner’s share of partnership liabilities is treated as a cash contribution, increasing the partner’s outside basis. Under Section 752(b), a decrease in a partner’s share of partnership liabilities is treated as a cash distribution, reducing the partner’s outside basis.

This treatment is consistent with Crane v. Commissioner, 331 U.S. 1, 67 S. Ct. 1047 (1947). Under *Crane*, taxpayers include the amount of debt assumed in the basis of property acquired, even if the debt is nonrecourse. The assumption is that liabilities will be repaid. On the flip side, the relief of liabilities is included in sale proceeds. This general treatment is extended to the treatment of partnership liabilities. Thus, partnership liabilities allocated to a partner are included in the basis of the partner’s interest, based on assumption that, under the **aggregate** theory, the

assumption of liabilities by the partnership is essentially an assumption by the partners.

Recourse – any partner is personally liable.

Recourse liabilities are allocated based on how the partners share losses, or more technically, based on each partners' share of the economic risk of loss for a partnership liability. A partner bears the economic risk of loss to the extent a partner would be required to satisfy a liability if the assets of the partnership were insufficient to do so.

This analysis is based on all contractual agreements (e.g., guarantees, the partnership agreement, etc...), as well as state law provisions (e.g., limited partner or LLC member).

Nonrecourse – no partner is personally liable.

Nonrecourse liabilities are allocated, conceptually, based on how the partners share profits.

V. Allocation of partnership liabilities – general.

Introduction

All (no more, no less) of a partnership's liabilities must be allocated among the partners. Under Sections 752(a) and (b), the assumption by a partner of a partnership liability is treated as a cash contribution to the partnership, while the assumption by the partnership of a partner's liability is treated as a distribution of cash to that partner. As a partner's allocable share of partnership liabilities changes, the partner is likewise treated as contributing cash or receiving cash from the partnership. The basis of each partner's interest in the partnership is continually being adjusted for changes in its share of partnership liabilities.

Importance of allocating liabilities among the partners

Basis for deducting losses.

Avoiding gain on the contribution of liabilities to a partnership.

Ability to receive cash distributions without recognition of gain under 731.

Coordination with loss allocation under 704(b) and 704(c)

Economic risk of loss analysis under 704(b) relied on in allocating recourse liabilities. That is, the provisions of the partnership agreement affecting the partners' capital (i.e., contributions, distributions, and allocations of income or loss) are the basis for determining which partners are obligated to fund partnership debts if the assets of the partnership are not sufficient to do so.

704(c) gain allocation principles are followed in allocating nonrecourse debt secured by property contributed to a partnership.

Definition of liabilities

Excludes cash basis payables

Excludes contingent liabilities devoid of economic reality (1.752-2(b)(4)).

Excludes items that would give rise to a deduction if paid (e.g., cash basis liabilities).

Two systems – one for recourse debt and one for nonrecourse debt

VI. Recourse liabilities.

Recourse liabilities are allocated to a partner to the extent the partner, or a person related to that partner, bears the economic risk of loss for the liability.

A partner bears the risk of loss for a recourse debt to the extent the partner would have to satisfy the liability if all of the partnership assets became worthless and all of its debt became due and payable.

In order to perform this analysis, the regulations assume a constructive liquidation under a worst case scenario:

All of partnership's liabilities become due,

Any property pledged as security for a liability is transferred to the creditor,

The partnership disposes of its assets for no consideration (other than the relief of any nonrecourse debt),

The loss on the deemed sale (or gain in the case of nonrecourse debt – this would always be a gain since the asset securing the debt is worthless) is allocated to the partners under the partnership

agreement taking into consideration the 704(b) safe harbors or PIP rules if the agreement lacks the safe harbors,

the partnership liquidates.

In general, a partner bears the risk of loss for a liability to the extent it would have to:

contribute funds to the partnership to satisfy creditors,

pay the creditor directly,

reimburse another partner who satisfied the liability but is entitled to reimbursement under state law or a contractual obligation,

or

the partner makes a nonrecourse loan to a partnership since the partner bears the risk of loss as the lender.

All of the facts and circumstances must be considered in determining a partner's payment obligation, including:

contractual obligations outside the partnership agreement such as guarantees, indemnities, etc.,

obligations to contribute funds under the partnership agreement,

state law obligations (i.e., general partner's obligation to satisfy the partnership's recourse debts),

the obligation to transfer property pledged as security – a partner's obligation is equal to the value of the property on the date pledged,

in the case of loans guaranteed by a limited partner, whether the limited is entitled to reimbursement from the general partner (rights of subrogation)

Other rules.

A partner is deemed to satisfy its obligations regardless of its net worth (1.752-2(b)(6)),

Obligations are ignored if they are subject to contingencies that make it unlikely that the partner will ever have to satisfy the obligation,

If an obligation does not have to be satisfied within a reasonable period of time, only the present value of the obligation is taken into account.

VII. Nonrecourse liabilities.

Generally, nonrecourse liabilities are allocated based on the partners' interest in profits.

Three tiers or tranches

Partnership minimum gain

This tier applies to minimum gains created by the partnership's operations,

There is no minimum gain on the date property is contributed to a partnership since the book value of the property is its FMV and the partnership minimum gain is determined with reference to the property's book value.

704(c) minimum gain

This is the gain recognized if the partnership disposed of contributed property for the amount of nonrecourse debt. The 704(c) minimum gain may be less than the pre-contribution gain inherent in the property.

The 704(c) method elected by the partnership may affect the amount of nonrecourse debt allocated under this tier. See Rev Rule 95-41.

This same analysis applies to reverse 704(c) allocations

Excess (i.e., remaining) nonrecourse debts – may be allocated in any of several ways:

Share of partnership profits based on the facts and circumstances (i.e., partnership agreement provides no guidance). This is a subjective analysis. For this purposes, the 704(c) gain in excess of the 704(c) minimum gain allocated under tier 2 is a factor to be considered. See Rev Rule 95-41

The partnership agreement may specify the partner's profits interest for this purpose. To be respected, the percentage specified must be consistent with the allocation of some significant item of the partnership that has substantial

economic effect. Since 704(c) allocations do not have substantial economic effect, they cannot be used under this alternative.

In accordance with the manner in which *tax* deductions attributed to the nonrecourse debt will be allocated. Thus, the allocations under 704(c) must be taken into consideration. In the facts in Rev Rule 95-41, all of the nonrecourse debt is allocated to the noncontributing partner since the ceiling rule results in all depreciation deductions being allocated to this partner.

The excess nonrecourse debt may be allocated to the contributing partner to the extent the pre-contribution gain exceeds the 704(c) minimum gain.

VIII. Allocations attributed to nonrecourse debt.

Recall the general substantial economic effect requirements:

- i) In order for a loss allocation to have economic effect, the loss must be allocated to the partners who are bearing the risk of loss. In the case of recourse debt, the partner who is obligated to contribute money to the partnership if the partnership is not able to satisfy a debt is therefore entitled to the losses created by the use of such debt. With nonrecourse debt, no partner is liable for the debt, therefore, allocations of loss created by the debt cannot have economic effect. The question therefore exists, how should such losses be allocated?
- ii) A partner cannot be allocated a loss if such loss would create a negative capital account beyond the partner's restoration obligation. Under the general economic effect rules, a partner is only obligated to restore a deficit to the extent the partner has to contribute money (or property) to the partnership (due to a DRO, state law, etc...). Under the nonrecourse debt provisions, a partner is also deemed obligated to restore a deficit capital account if a partner is guaranteed to be allocated income in the future.

General.

Nonrecourse is debt for which no partner, or person related to a partner is personally liable. Since no partner is personally liable, allocations of deductions attributed to nonrecourse debt cannot have substantial economic effect as no member is bearing the risk of loss.

Crane v Commissioner, 331 U.S. 1, 67 S. Ct. 1047 (1947) – nonrecourse debt is included in cost basis of encumbered property. Depreciation is

therefore allowed on the cost basis attributed to the nonrecourse debt financing. This decision makes sense in light of *Tufts*.

Commissioner v. Tufts, 461 U.S. 300, 103 S. Ct. 1826 (1983) – relief of nonrecourse debt is treated as proceeds, regardless of the actual value of the asset. This decision justifies the treatment in *Crane*, because any deduction attributed to the nonrecourse financing is guaranteed to result in gain on the disposition of the property.

Tufts and Crane form the foundation for the minimum gain provision fundamental to the nonrecourse deduction provisions under Section 704(b).

Tufts/Crane example

The AB partnership finances the purchase of a building entirely with the proceeds of a \$100,000 nonrecourse loan. Under *Crane*, the partnership is entitled to depreciation computed on the \$100,000 purchase price. The first year net loss of the partnership is \$5,000, all of which is attributed to depreciation expense on the building. Under *Tufts*, the partnership would recognize \$5,000 of gain if it transferred the property to the lender in satisfaction of the loan. The partnership is therefore guaranteed to have at least \$5,000 of gain upon the disposition of the building – this is therefore referred to as the amount of “minimum gain”.

Under the nonrecourse deduction provisions, the \$5,000 increase in the amount of minimum gain during the year is the amount of “nonrecourse deductions” for the year. The cumulative amount of nonrecourse deductions taken by the partnership is referred to as the “minimum gain chargeback”.

Notice that the capital of A and B is negative by \$5,000. This is permitted because the capital is guaranteed to be increased to zero, at a minimum, due to the minimum gain chargeback provision. Thus, the partners are deemed to be obligated to restore a deficit in their capital accounts to the extent of their share of the partnership’s minimum gain.

IX. Definitions.

Example

Developer contributes \$1,000 and Investor contributes \$9,000 to a partnership which obtains a nonrecourse loan for \$90,000 and purchases a commercial building for \$100,000. The terms of the debt are interest only for 10 years. Developer is obligated to restore a deficit. Investor is not obligated, but the agreement meets the alternate test for economic effect. The partnership allocates income and losses 90% to Investor and 10% to Developer until aggregate partnership income equals aggregate partnership losses (i.e., most likely losses in early years and income in later years) after which income and losses are allocated

50/50. Assume that rental income equals rental expenses, and that the partnership incurs a loss of \$5,000 per year attributed to depreciation of the building.

Partnership minimum gain – this is the amount of gain that a partnership would realize if it disposed of property subject to a nonrecourse liability for no consideration other than satisfaction of the debt. In other words, the amount by which the nonrecourse debt exceeds the basis of the property securing the debt.

Under our example, there will be no minimum gain for the first two years. At the end of year two, the amount of the nonrecourse debt and the basis of the building will both be \$90,000. There will be a \$5,000 minimum gain at the end of year three, however, the amount by which the \$90,000 nonrecourse debt balance exceeds the \$85,000 basis of the building.

Nonrecourse deductions – equal the increase in the amount of minimum gain during the year.

Increase in minimum gain during the year can result from:

Reduction of basis (due to depreciation) below amount of nonrecourse debt. See example above where \$5,000 minimum gain results in year 3.

Additional nonrecourse borrowing where the proceeds are not distributed. If the proceeds are not distributed, the borrowing is assumed to generate nonrecourse deductions even if the increase in minimum gain exceeds the cost recovery deductions on the secured property. This effectively recharacterizes deductions funded from other sources to nonrecourse deductions (e.g., recourse debt).

Does this make sense? Whether right or wrong, nonrecourse deductions created by the borrowing will also be charged back as gain under the minimum gain chargeback provisions.

Distribution of nonrecourse liability proceeds allocable to an increase in minimum gain.

Assume in our example, that on the first day of year 4 the partnership borrows \$20,000 and distributes \$18,000 to Investor and \$2,000 to Developer. This creates an increase in minimum gain equal to the amounts distributed to each partner.

The increase in minimum gain does not create nonrecourse deductions. Why not? Because capital would become negative in excess of the deemed obligation to restore it due to the minimum

gain chargeback. That is, capital would be reduced by the distribution and any nonrecourse deductions created by the new loan, but the chargeback will only apply to the first \$20,000. [Note that there would not be any additional deductions created in the above example since all the debt is nonrecourse. Consider a scenario where there is both recourse and nonrecourse debt. In this case, the recourse deductions could be misinterpreted as nonrecourse deductions.]

The additional minimum gain prevents the QIO from applying since each partner is treated as being obligated to restore a deficit to the extent of the additional minimum gain/minimum gain chargeback. The QIO would otherwise apply to the extent the distribution creates a negative capital account (beyond the partners obligation to restore the deficit).

Partner's share of partnership minimum gain – equals the sum of:

nonrecourse deductions allocated to the partner, plus

the partner's share of nonrecourse liability proceeds allocable to an increase in minimum gain, less

the partner's share of reductions in minimum gain (consider minimum gain chargeback, conversion of nonrecourse debt to recourse, contributions to capital used to reduce nonrecourse debt).

Minimum gain chargeback – gain triggered due to a partner's reduction in its share of minimum gain.

Disposition of the property securing the nonrecourse debt

Assume in our example that the partnership disposes of the property at the beginning of year 4 for the amount of the nonrecourse debt balance of \$90,000 (whether due to a foreclosure or otherwise). This results in gain of \$5,000 (\$90,000 proceeds vs. \$85,000 basis). The gain is allocated \$500 to Developer and \$4,500 to Investor, since these are the amounts of nonrecourse deductions allocated to each partner under the agreement.

Principal of a nonrecourse liability is reduced below the basis of the property securing the liability

The minimum gain chargeback is not triggered for a partner if the decrease in nonrecourse debt is attributed to contribution by such partner. This makes sense since the partner's capital is increased by the contribution. The other partners, however, must be allocated gain equal to their

share of the minimum gain chargeback, however, since there capital is now negative beyond the amount of minimum gain to be generated upon the disposition of the property.

Nonrecourse debt converted to recourse

The minimum gain chargeback does not apply to a partner to the extent a partner bears the risk of loss for the recourse debt. The minimum gain chargeback does apply, however, to the other partners.

Safe harbor test.

Throughout the life of the partnership, the agreement satisfies the Big Three or the Alternate Test for Economic Effect;

Nonrecourse deductions are allocated in a manner that is reasonably consistent with allocations (having substantial economic effect) of some other partnership item attributed to the property securing the nonrecourse debt.

The agreement contains a minimum gain chargeback provision

The agreement complies with the basis 704(b) requirements

X. Ordering.

Nonrecourse deductions take precedence over recourse deductions.

Partnership nonrecourse deductions and partner nonrecourse deductions should not be competing for the same loss. The allocation of basis based on debt priority should determine the amount of the partnership's loss attributed to such deductions.

XI. Allocation of LIHTC.

Because the allocation of tax credits is not reflected in adjustments to partners' capital accounts, such allocations cannot have economic effect. The regulations provide rules governing these allocations. With respect to LIHTC, the rule provides that if a partnership expenditure that gives rise to a tax credit also gives rise to a valid allocation of partnership loss or deduction (or other downward capital account adjustment) then the allocation of the tax credit shall be made in the same proportion as such loss or deduction.

Thus, it is important to apply correctly the substantial economic effect test since it will in effect govern how credits are allocated. If losses or deductions are not allocable to the limited partner, for example, because the limited partner has

utilized all of its cash contribution through previous distributions or deductions, and further deductions are allocable to the general partner either because the general partner has made a substantial capital contribution or there is recourse debt, then the LIHTC allocation would be required to be made to the general partner.

XII. Excess Debt and After Acquired Debt.

Both the IRS and the courts have generally taken the position that nonrecourse debt in excess of the fair market value of the property to which it relates does not generate basis. This would hold true for both basis for depreciation purposes and eligible basis for calculating the LIHTC. It is not altogether clear whether the entire amount of an excess debt obligation would be ignored, or simply the amount in excess of fair market value.

In any event, this rule is the reason for investors to examine the terms of most soft debt to get comfortable with its validity. In circumstances where the debt might be viewed as excess, one approach has been to simply not include any of the debt in basis. This, of course, has the potential of limiting the amount of LIHTC available, depending on the overall financing scheme.

This issue is raised sometimes in a more stealth manner – after acquired debt. For example, many times a project will obtain Federal Home Loan Bank AHP funds post-closing. These funds typically are treated as a grant to the sponsor, with the sponsor either loaning or contributing the funds into the project partnership. Either way, the investor needs to analyze these funds. If a loan, is there sufficient value in the project to justify treatment of such? If a contribution, will that have an adverse impact on the ability of the investor to be allocated deductions attributable to nonrecourse debt?

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