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LOW-INCOME HOUSING UNDER THE NEW CONSERVATISM: TRICKLE DOWN OR DRY UP?

I. INTRODUCTION

The goal of providing a "decent home and suitable living environment for every American" has become an uncertain prospect at best. Although our society does not constitutionally protect the right to decent housing, Congress first expressed that the provision of adequate housing was of primary importance in the Housing Act of 1949. In the past few years, the federal government has tried to limit its role in providing adequate housing. As a result, tax incentives have become an important factor responsible for increasing the role of the private sector in housing projects. Private investors interested in investment tax credit and accelerated depreciation enter into limited partnerships to finance the construction and rehabilitation of low-income housing. The participation of "charitable" or-

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2. Id.; see also Lindsey v. Normet, 405 U.S. 56, 74 (1972). "The constitution does not provide judicial remedies for every social and economic ill. We are unable to perceive in that document any constitutional guarantee of access to dwelling of a particular quality." Id.
3. See infra notes 13-19 and accompanying text.
4. An investment tax credit [hereinafter cited as ITC] is a fixed amount of money which is credited against a taxpayer's individual federal tax obligation. These credits are available only for special qualified types of property. I.R.C. §§ 38, 48 (1982). For a further discussion of the various tax incentives available, see infra note 23.
5. Depreciation is a device to spread the cost of acquiring property over the period of time the property is to be used. Each depreciation deduction offsets an equal amount of ordinary income. I.R.C. § 167. Accelerated depreciation allows one to spread the cost of property over a shorter period of time; thus, larger amounts of ordinary income can be sheltered earlier. I.R.C. § 168. For a further discussion, see infra notes 6, 23, 93-96 and accompanying text.
6. This type of limited partnership is the basic structure of most investment tax shelters. Investing limited partners can both shelter their individual incomes by their proportionate share of partnership depreciation deductions, and they may limit their liability to the extent of their investment. To the extent a limited partner takes depreciation deductions, his tax obligation is deferred, not forgiven. For a further discussion, see infra notes 23, 36-49, 93-96 and accompanying text.
7. Throughout this comment the word "charitable" will be used to convey a specific and limited meaning. A "charitable organization" or "tax exempt charity" refers to an organization committed to the accomplishment of a specific social purpose as set out in I.R.C. § 501(c)(3). See infra notes 52-57 and accompanying text. A "charitable class" means those who will benefit by the activities of the charitable organization. In this context, charitable does not refer to the qualities of munificence or altruism.
organizations in combination with private sector investments has created, and may continue to create, unique opportunities to develop and preserve low-income housing. By entering into limited partnership agreements, tax exempt charities may promote the construction and rehabilitation of additional housing units for handicapped, elderly and low-income persons; furthermore, they can ensure that those units will remain available to the charitable class. The participation of charitable organizations, however, has been threatened by certain provisions of the Deficit Reduction Act of 1984.  

Despite the great potential offered by this unique limited partnership vehicle for raising capital to provide decent, affordable and long term low-income housing, provisions of the 1984 Act have cast doubt upon the future of tax exempt organizations in real estate syndications. Those provisions of the Act regulating tax exempt entity leasing have a broad and restrictive effect which severely limits projects involving tax exempt entities from reaping the benefits of accelerated depreciation and investment tax credit. Such a disincentive will have a chilling effect upon the participation of charitable organizations in real estate syndications. In order to effectively involve the private sector in promoting the availability and stability of low-income housing, certain changes must be made to the 1984 Act and further explanations of the 1984 Act must be set forth.

Section II of this comment examines the changing roles of the federal government and the private sector, and Section III analyzes the benefits and limitations associated with the introduction of charitable organizations into private sector investments. In Section IV some of the problems and uncertainties created by the 1984 Act will be addressed, and Section V suggests changes which will facilitate the effective involvement of charitable organizations with the private sector to meet the nation’s housing needs.

II. THE CHANGING ROLES OF THE FEDERAL GOVERNMENT AND THE PRIVATE SECTOR

Since the early 1970s, severe economic problems have developed at an alarming rate which have brought into serious question the ability of our economic system to house its people. The double digit

8. Deficit Reduction Act, Pub. L. No. 96-369 (1984). This comment deals only with division A of the Deficit Reduction Act which is called the Tax Reform Act of 1984 [hereinafter cited as the Act]. The relevant portions of the Act are codified in I.R.C. § 168(j) and § 7701(e). See infra text accompanying notes 91-147.

9. See infra notes 91-109 and accompanying text.
inflation of the 1970s caused the cost of building new housing to skyrocket, and the increased investment and speculation in used housing has made older shelters equally unaffordable to low and medium-income families. Furthermore, mortgage interest rates which have significantly increased since the late 1950s, have put additional pressure on the supply of available housing. The enormous federal deficit and the heavy federal borrowing needed to refinance that deficit, “is certain to keep pressure on interest rates and the home buying market.”

These same problems which have plagued the private housing industry are now afflicting the ability of the federal government to provide public housing. In 1981, Congress attempted to reduce the federal deficit by cutting federal spending for housing by nearly fifty percent. Furthermore, the emphasis of the federal housing programs was shifted from production of new housing to consumption of existing housing in order to reflect an emerging “New Federalism.” Even though President Reagan and his Commission on Housing have affirmed, in the strongest terms, the national commitment to a continuing role for the federal government in providing decent housing, a new and less prominent role for the federal gov-

14. Comment, Federal Budget Cuts in Housing: Is There No Place Like A Decent Home?, 10 J. LEGIS. 457, 465-66 (1983). The author traces the evolution of “supply side federal housing programs” and the shift in focus to a more consumer oriented approach during the Nixon Administration. This new approach “favored diminishing federal responsibility for public housing by directly subsidizing housing demand, rather than continuing to pour federal grant dollars into the supply side of the market by funding construction firms and landlords [because] . . . federal housing money would never reach those who needed it most—the lowest of low-income families.” Id.
15. W. McKENNA, THE REPORT OF THE PRESIDENT'S COMM'N ON HOUSING xxii (1982). President Reagan established a 30-person commission to investigate the housing needs of Americans and to recommend to him and to the Secretary of Housing and Urban Development (HUD) options for the development of a national housing policy. Id. at xv. It is interesting to note that the commission was stacked with representatives of the banking, real estate and construction business world; 29 of the commission's 30 members were republicans, 25 were white males, and there were no representatives of the construction trades or housing/consumer rights organizations. Hartman, supra note 10, at 23.
government is inevitable. The Housing Commission Report proposed that a "consumer oriented Housing Payments Program" become the major housing program for low-income households. Those programs would be carried out in a way to reduce federal control and regulation and increase state and local control and accountability.

Recognizing the inability of federal housing payments to effectively address the problems of housing adequacy and supply, the Commission proposed the addition of a Housing Component to the Community Development Block Grant Program. This program would provide funds for new construction and rehabilitation which would be allocated to and administered by local, regional and state agencies. This combination of budget cuts and the reduced role of the federal government in providing low-cost housing has led housing specialists to consider the prospect of additional low-cost housing as "bleak."

Another essential component of the "New Federalism," beyond reducing the federal regulatory and financial involvement in low-income housing and delegating the fiscal and administrative responsibilities to local and state authorities, relies on the involvement of the private sector. The Housing Commission Report noted that, in addition to new construction, some of the necessary rental stock must

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16. W. MCKENNA, supra note 15 at 3-4. Others have described the harsh realities of the 1980s as follows: "In short, don't expect any more public bailouts from Uncle Sam. The federal government has sent the message loud and clear: find new and creative solutions to your problems, involve the private sector, be more efficient and businesslike but, whatever you do, don't call us." Howell, Project Syndication: How It Works, 41 J. HOUSING 107 (1984).

17. W. MCKENNA, supra note 15, at 35. See also Schecter, Closing The Gap Between Need And Provision, Soc'y, March-April 1984, at 40, in which the author points out that the Reagan housing policy marks a retreat from past policies of meeting the housing needs of low-income people through government-assisted housing production programs. Instead of meeting those needs through targeted supply increases, the new policy would issue partial-rent-payments vouchers. Such a policy "could create added demands in rental markets which are bound to remain in short supply for several years, following the depressed production years of 1980-82." Id. at 42.


20. See Kabaker, Outlook For Low Cost Housing Called Bleak, NATION'S CITIES WEEKLY, March 15, 1982, at 2. See also Nenno, Housing Allowances Are Not Enough, Soc'y, at 54. Arguing that federal assistance is required to improve the supply and condition of housing, the author contends that there is an urgent need to reestablish new construction and major rehabilitation as a housing assistance mechanism. Id. at 54. More recent reports support her position as low-income housing resources are unable to keep up with demand and cities are unable to meet the needs of the homeless. [Current Developments], HOUS. & DEV. REP. (BNA) 50, 56 (June 18, 1984).

come from the conversion of commercial and industrial buildings to residential use, and from the transformation of existing houses and large apartments to provide more rental units.\textsuperscript{22} At first glance, the 1981 Economic Recovery Tax Act (ERTA), the 1984 Act, and other provisions of the Internal Revenue Code seem to provide incentives for the private sector to construct and rehabilitate low-cost public housing.\textsuperscript{23} Despite outward appearances, however, expert real estate syndicators in the field of low-income housing predict that the incentive of accelerated depreciation is insufficient, in the absence of a sensible financing mechanism, to spur the creation of new housing. With supply down and demand up, the accelerated depreciation incentive “will simply make housing more valuable.”\textsuperscript{24}

The recent tax acts fail to provide adequate incentives to stimulate private sector involvement in increasing the supply of low-cost housing. One foreseeable consequence of this failure is that a new business will emerge in lieu of the creation of new housing—the resyndication of existing subsidized housing.\textsuperscript{25} The net effect of this

\textsuperscript{22} Id. at xxviii.


The 1984 Act increased the recovery period to 18 years for all residential properties except low-income housing. I.R.C. \$ 168 (b)(2), (4) (CCH-1984). The 1984 Act also extended the application of I.R.C. \$ 167(k) (CCH-1984), which allows a 60-month recovery period for the depreciation of expenditures of up to \$40,000 for the rehabilitation of low-income rental housing. In addition, certain investment tax credits may be available for the qualified rehabilitation of low-income housing. I.R.C. §§ 38, 48 (a)(1)(E), and (g)(2)(D) (CCH-1984). These incentives allow taxpayers, especially those in the highest tax bracket, to shelter their present incomes from further taxation. Tax credits will directly offset a portion of the tax imposed by the Internal Revenue Service (IRS). Depreciation gives rise to deductions against one's taxable income which effectively defers the payment of certain taxes and reduces the amount of taxable income by converting ordinary income into capital gains. The capital gains may be recaptured and converted into ordinary income upon disposition of the property pursuant to I.R.C. \$ 1250.

\textsuperscript{24} D. SMITH, SUBSIDIZED HOUSING AS A TAX SHELTER 4-6 (1982). Smith believes “the shortage is approaching crisis proportions.” Id.

\textsuperscript{25} Id. at 7. The author argues:

The 1981 Tax Act has made existing owners of subsidized syndications more willing to sell, and potential investors much more willing to buy. As new construction financing evaporates, the availability of new construction housing as a tax shelter should continue to dwindle. Consequently, high-bracketed inves-
type of private sector involvement will be to reduce the amount of available low-cost shelter. Because tax sheltering is the primary investment motive in subsidized housing, overpayment for a subsidized housing syndication would allow limited partners in the investment partnership to take greater depreciation deductions and, therefore, to shelter more income. To justify these hyped-up valuations and the inflated debt required to finance such a purchase, a new "reversion/shelter" approach to valuation has emerged. This new valuation method requires an appraiser to determine the minimum holding period contractually permitted, after which the property will no longer be operated as government-regulated low-income housing. The property may then be, typically, converted into condominiums, cooperatives or other more profitable forms of rental property in order to pay off the inflated debt.

Due to the earlier influx of tax-sheltered investment dollars into the construction of new housing, and the rehabilitation of old dwellings, investors have been willing to speculate upon the gentrification of old neighborhoods. This upgrading of old, run down, low-income

Id. See also The New Allure of Subsidized Housing, NATION'S BUS., Nov. 1983, at 20.

26. See supra notes 5, 6, and 23.

27. Because every yearly depreciation deduction is a fixed proportion of the cost of the property, a high original cost will yield high deductions and shelter more income.

28. Where nonrecourse financing is an element of the purchase price, inflated value becomes a risk and arm's-length negotiation provides no protection. Consequently, tax courts and the IRS have generally required an independent verification that the purchase price does not exceed market value, testimony of expert appraisers or a written appraisal carries great weight.


29. Id. at 326, 333-36. Under such an approach, the value of the subsidized housing units is adjusted upward to reflect the value of the expected net operating income, the tax benefits available during the holding period, and the residual value of the expected reversion. To measure the reversion, an appraiser determines the minimum holding period contractually permitted, after which the property will no longer be operated as government-regulated low-income housing. Id. For a further discussion of the residual value of a low-income real estate syndication, see infra note 46 and accompanying text.

30. D. SMITH, supra note 24, at 73-82. See also Horowitz, Condominium Conversion Controls, SOC'Y, March-April 1984, at 58. The author cites the accelerating incidence of rental to condominium conversion as a cause of involuntary displacement of low and moderate-income families through the erosion of the supply of rental housing. Even though conversions make available more opportunities for home ownership, a "policy of laissez-faire is unacceptable. It represents the implicit assumption that landlords—but not tenants—are entitled to legal protection." Id. at 60. For a discussion of some of the problems created by the conversion of rental property, see U.S. DEP'T OF HOUSING AND URBAN DEVELOPMENT, CONVERSION OF RENTAL HOUSING TO CONDOMINIUMS AND COOPERATIVES: STATE AND LOCAL CONVERSION REGULATIONS 47-59 (1981).
housing has typically attracted young urban professionals into older neighborhoods and has displaced the less fortunate tenants of the previously low-income communities.\(^3\) Thus, many successful syndications of low-cost housing are predicated on the expected conversion of the low-cost housing units into more profitable investments which will displace low-income tenants, reduce the already short supply of low-income housing, and further exacerbate the crisis of low-cost shelter.\(^3\)

III. **The Introduction of Charities into Investment Partnerships**

A. **Opportunities**

Despite the increasing number of factors which push the goal of decent and affordable housing further from realization, a number of positive steps may be and have been taken toward achieving that goal.\(^8\) The greatest potential may arise from tax-exempt organiza-

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31. Hartman, *supra* note 10, at 19. The author notes that the displacement of residents from their homes and communities is occurring at disturbingly high rates and for various reasons, including gentrification. *Id.* See also *Urban Revival: A Dream Yet To Come True*, U.S. *NEWS & WORLD REP.*, Feb. 20, 1984, at 51. “Yet along with this facelift of sagging neighborhoods—spurred by young professionals who seek housing bargains and tax shelters—have come rising rents and taxes that drive out low-income residents and many mom and pop businesses.” *Id.*

32. Wingo & Wolch, *Urban Land Policy Under The New Conservatism*, 5 *URB. L. & POLICY* 315, 327 (1982). It is uncertain what percentage of displacement is due to gentrification and what percentage of tax sheltered low-income housing projects are converted into condominiums and other higher profit forms of property. What is certain is that the reversion potential in tax sheltered housing arrangements will not be left unexploited by “benevolent” developers and investors. Instead, as others have suggested, the federal government “could make rehabilitation and development incentives available only—or on more attractive terms—to those who produce housing that is permanently placed outside the speculative sector.” Hartman, *supra* note 10, at 25. For a discussion of the relationship between conversions and rental supply, see Horowitz, *supra* note 30, at 64.

33. For example: 1) At the federal level, I.R.C. § 167(k), which provides a 60-month recovery period for $20,000 of qualified rehabilitation of low-income housing, was supplemented by ERTA, and an additional $20,000 of rehabilitation expenditures became available if “the program provides for sale of the units to tenants demonstrating home ownership responsibility” at a fixed reduced price. I.R.C. § 167(k)(2)(B) (CCH 1984); 2) At the state and local levels, the City of San Francisco responded to its housing shortage with a plan requiring office developers to build, rehabilitate, sponsor or finance housing in order to receive permission to build. See Diamond, *The San Francisco Office/Housing Program: Social Policy Underwritten By Private Enterprise*, 7 *HARV. ENVT'L. L. REV.* 449 (1983). For a discussion of local ordinances regulating eviction from and condominium conversion of housing subject to rent control, see Comment, *Flynn v. City of Cambridge: Guideposts For The Control Of Condominium Conversions*, 33 *MERCEY L. REV.* 949 (1982); 3) In the private sector, there are national organizations committed to the provision and maintenance of decent, affordable housing for those of low and moderate incomes. The National Housing Law Project and the Na-
tions which enter into investment partnerships with the private sector to finance charitable activities. The participation of charities in low-cost housing syndications offers a tremendous vehicle for effective involvement of the private sector in meeting the nation's housing needs. As a general partner, a tax exempt charity may join with profit motivated investors in a limited partnership to raise capital. The charitable general partner can then ensure that the funds and services it contributes are properly used to accomplish charitable objectives.

The basic structure underlying all project syndications is the limited partnership. The primary incentive for using a limited partnership as an investment vehicle is two-fold: 1) the partnership can pass through any losses and other tax deductions generated by the partnership, to offset the limited partner's income from other sources; and 2) still limit the liability of the limited partners to their original investment. For a tax exempt charity, the limited partnership offers an excellent vehicle to raise capital and realize its charitable goals. In addition to being an important source of capital, a limited partnership can be a particularly appropriate vehicle for conducting charitable activities because the tax exempt entity, as general partner, will have control over the invested funds and can insure that those funds will be used for charitable purposes.

34. See also Group Fights Displacement of Poor, NAT'L. CATH. REP., Feb. 20, 1981, at 2.

35. Purcell & Yanowitz, supra note 34.

36. Howell, supra note 16; see also, supra note 6.

37. These losses and tax deductions include depreciation deductions under I.R.C. §§ 167, 168 (see supra notes 5 and 23) and amortization of organization fees under I.R.C. § 709.

38. See generally Aslanides, Cardinali, Haysworth, Lane & Niesan, Limited Partnerships - What's Next And What's Left?, 34 BUS. LAW. 257 (1978) [hereinafter cited as Aslanides]. For an overview of the partnership taxation issues, see infra note 106 and accompanying text. For a basic definition of a tax shelter, see supra note 6 and accompanying text.

39. See Aslanides, supra note 38; see also UNIF. LIMITED PARTNERSHIP ACT § 7 (1916).

40. Comment, supra note 34, at 1358.

41. Id. at 1360. Because control does not necessarily follow ownership in the property, the general partner may retain exclusive management and control while possessing only an insignificant financial interest, by drafting an appropriate partnership agreement. Aslanides, supra note 38, at 259-62. In addition, for the charitable organization to act as general partner in a for-profit syndication, the organization must comply with the restrictions set forth in I.R.C. § 501(c) and the regulations thereunder. See infra notes 50-77 and accompanying text. This will further promote the charitable applications of the capital raised by the syndication.
More specifically, in the context of low-income housing, the charitable ends sought are primarily the creation and preservation of affordable and decent shelter. Various strategies might facilitate this end, but the best method to assure long-term affordability would be to structure the partnership so that the property is eventually returned to the ownership and control of the nonprofit organization. In order to make possible such a transfer, the tax exempt charitable organization must have acquired a significant equity interest in the partnership. Because a charitable organization often has little capital to invest and its investment potential is limited, its significant economic interest is acquired through a "rear-end allocation" of the partnership interest in the residual value of the property. An example, which will serve as a model throughout this comment, will best illustrate the principles involved:

42. It is important to point out that the construction and development of low-income housing is not dependent on the participation of charitable organizations. In fact, most low-income housing has been constructed by for-profit developers and investors working through various Housing and Urban Development (HUD) programs. Although the restrictions imposed by HUD require such units to be affordable to low and moderate income families, the long term affordability of these housing units can be extended beyond those limits by imposition of rent and use restrictions on future sales. These techniques may be utilized independent of or in conjunction with a charitable nonprofit entity. For example, if one owned the underlying land, he could enter into a ground lease with the real estate syndication and include in that lease covenants restricting the use of the subsequent development of the property. This technique would not require a tax exempt charity to participate in the syndication. Nolan, Smith & Power, Syndicating Low- and Moderate-Income Housing, at 47-53 (unpublished manuscript, Nat'l Housing Law Project, 1950 Addison St., Berkeley, Cal. 94704).

43. The property is returned to the nonprofit entity from the partnership by a subsequent sale or other transfer after a period of time. This time period is generally a tax shelter "burns out," i.e., when the depreciation rate is so reduced that the project will no longer shelter a substantial amount of the investor's personal income. Id.

44. See infra note 67.

45. The partnership agreement will provide that upon sale or refinancing of the property or termination of the partnership, the tax exempt entity becomes entitled to a substantial percentage of the proceeds, i.e., the equity or appreciation gain which would otherwise benefit the for-profit partners. For a more detailed treatment of partnership allocations, see infra note 106 and accompanying text. It is important to note that increased equity participation may also be achieved by special allocations of partnership interests during the course of the partnership. See infra note 106.

46. The residual value of the property reflects its appreciation in value and the increased equity in the property resulting from appreciation and/or service of the debt taken out to finance the project. Also reflected in the residual value is the reversion potential resulting from termination of use restrictions. See supra note 29 and accompanying text.

47. This model is very narrowly tailored to demonstrate the basic role of a tax-exempt entity in a real estate syndication and the effect of the tax-exempt entity leasing provisions of the 1984 Act on the participation of charitable entities in such real estate syndications. For a more thorough model including the broad range of finance, rehabilitation expense and other relevant tax issues, see Power, The Impact Of The Tax Reform Act of 1984 On Syndication For Low-Income Housing Owned By Non-Profits, HOUSING L. BULL., Sept./Oct. 1984, at 11.
E is a tax exempt nonprofit organization which owns and/or operates H, a low-income housing project. To raise capital to improve or build additional housing, E sells H to LP, a limited partnership set up to operate H as low-income housing. E, acting alone or with a for-profit partner, is the managing General Partner. E is allocated a minimal percentage (one percent for example) of partnership items of operating income and loss, and the remaining percentage is allocated to the limited partnership. Upon sale of H and/or dissolution of LP, a substantial percentage of the residual liquidating proceeds are allocated to E.48

This increased equity interest resulting from the rear-end allocation of residual partnership interests puts the charitable organization in a position to buy back or determine the future disposition of the housing project.49 In those syndications in which the tax exempt partner is entitled to the residual proceeds or some equity potential, the partnership arrangements should satisfy the limitations under section 501(c) and promote the preservation of long-term low-income housing.

B. Limitations Imposed Upon Tax Exempt Organizations

Despite the many potential benefits which a tax exempt general partner might add to a low-income real estate syndication, the Internal Revenue Service has often rejected the participation of such charities in limited partnerships. The Service challenges these arrangements by arguing that the charitable purpose of the tax exempt entity has been subrogated to the private interests of the “for-profit” partners.50 To determine whether an exempt organization furthers its charitable purpose, the IRS seems to have adopted a “means/ends” approach to determine whether the tax exempt organization

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48. This example represents only one method of ensuring that syndicated housing remains available to low-income tenants. The analysis that follows does not address all of the changes in the 1984 Act which might affect such a syndication, but rather is intended to make readers generally aware of the opportunities and pitfalls associated with this type of project.

49. Other techniques operate to put the charitable organization in a position to control the disposition of the project. For example, a nonprofit partner might negotiate in the partnership agreement an option or right of first refusal, at a fixed determinable price, on the sale of the project or dissolution of the partnership. Also, the partnership agreement may establish a sinking fund or special allocations to enhance the equity position of the nonprofit partner. In addition, various forms of debt mechanisms might be utilized to enhance the nonprofit entity control over the future disposition of the property. These various techniques can be effective, but the tax issues arising therefrom are extremely complex and require the attention of specialists in the field. See Nolan, Smith & Power, supra note 42.

satisfies the restrictions of Internal Revenue Code section 501(c)(3). The analysis focuses on whether: 1) the goal is charitable; 2) the means employed to reach the result are reasonably designed to achieve the charitable result; and 3) the scope of the charitable achievement is commensurate with the resources used.

1. *The Organizational and Operational Tests*

First, to meet the organizational test of I.R.C. section 501(c)(3), the entity must be organized “exclusively for one or more of the purposes specified” in section 501(c)(3). Thus, the partnership agreement and other articles of organization must not “empower the organization to engage, otherwise than as an insubstantial part of its activities, in activities which in themselves are not in furtherance of one or more exempt purposes.” The organizational test is one of the easiest hurdles to clear in order to maintain exempt status.

The second condition of section 501(c)(3) requires that an organization be “operated exclusively” for one or more exempt purposes; thus, such an organization must engage “primarily in activities which accomplish one or more of such exempt purposes.” The operational test, in contrast to the organizational test, is more complex and particularly ill-suited for dealing with limited partnerships.

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51. Purcell & Yanowitz, *supra* note 34. I.R.C. § 501(c)(3) (CCH-1984) exempts from taxation the following:

- Corporations, and any community chest, fund, or foundation, organized and operated exclusively for religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster national or international amateur sports competition (but only if no part of its activities involve the provision of athletic facilities or equipment), or for the prevention of cruelty to children or animals, no part of the net earnings of which inures to the benefit of any private shareholder or individual, no substantial part of the activities of which is carrying on propaganda, or otherwise attempting, to influence legislation, (except as otherwise provided in subsection (h)), and which does not participate in, or intervene in (including the publishing or distributing of statement), any political campaign on behalf of any candidate for public office.

52. *Id.* See also Rev. Rul. 64-182, 1964-1 C.B. 186. The discussion which follows is not a complete analysis of the complex § 501(c)(3) requirements, but only a general description of those restrictions which prevent parties other than the charitable class from receiving substantial benefits.


Because activities in furtherance of their charitable objectives also generate benefits for other parties, it is questionable whether the organization is being operated "exclusively" for an exempt purpose. When the Service challenges such arrangements, the courts focus on the organization's activities from which it will infer one or more purposes. If such activities reflect a nonexempt commercial purpose which is more than an insubstantial part of its activities, then these activities constitute a violation of the operational test.

2. Private Inurement and Conflict of Interest

Similar to and interrelated with the organizational and operational hurdles are the private inurement and conflict of interest objections. To further insure that those groups organized and operated for charitable purposes effectuate that purpose and proffer a benefit to the charitable class "commensurate in scope with its financial resources," the entity must provide that "no part of the net earnings . . . inures to the benefit of any private shareholder or individual." This clause is primarily designed to prevent self dealing by insiders of the charity, such as officers, directors and shareholders who have some degree of control and who might divert the organization's resources away from its charitable goals.

In the context of a limited partnership, the relationship between the charitable nonprofit organization, acting as a general partner, and the for-profit limited partners becomes more complex. Because a general partner has a fiduciary obligation to protect and promote the private investments of the limited partners, the Service has argued

57. See Comment, supra note 34, at 1364. See also Purcell & Yanowitz, Contingent Compensation Arrangements That Lack Safeguards May Jeopardize Exemption, 59 J. Tax’n 208 (1983).

58. See Comment, supra note 34, at 1364. See Plumstead Theatre Soc’y v. Commissioner, 74 T.C. 1324, 1331-3 (1980), aff’d, 675 F.2d 244 (9th Cir. 1982). The court looked closely to the facts of the case to determine whether the activities were directed primarily to commercial or charitable ends. See also Gen. Counsel’s Mem. 36293, in which the majority of the dwelling units were for moderate-income families; the organization was denied I.R.C. § 501(c)(3) status because it was not operated exclusively for charitable purposes.


61. B. Hopkins, supra note 55, at 211. See also I.R.S. Priv. Letter Rul. 84-37009. The minority view would also prevent such benefits from inuring to non-insiders with some level of control or influence over the organization. Kaplan, Real Estate Opportunities For Tax Exempt Organizations: Potentials And Pitfalls After Plumstead Theatre, 61 Taxes 291, 295-6 (1983).

62. Comment, Procedures And Remedies In Limited Partner’s Suits For Breach Of The General Partner’s Fiduciary Duty, 90 Harv. L. Rev. 763, 764 (1977). See also Comment, supra note 34, at 1368-70.
that conflicts of interest can force the charity to engage in practices that conflict with its public, charitable purpose and result in private benefit.\footnote{63} After \textit{Plumstead Theatre Society v. Commissioner},\footnote{64} it is clear that a tax exempt organization can be part of a for-profit partnership; however, the partnership agreement must be drafted so as to modify or waive any fiduciary or other obligations between partners which would compel the tax exempt partner to act contrary to its charitable purpose.\footnote{65} In \textit{Plumstead Theatre}, the court examined the arrangements between the partners and found that an arms-length transaction existed when the limited partners had no control over how the tax exempt general partner administered or managed its affairs, and when the general partner had no obligation to return any of the capital contributions from its own funds.\footnote{66}

Thus, in order to insulate the tax exempt general partner from conflicts of interest intrinsic to the limited partnership vehicle, certain safeguards must be provided in the partnership agreement to ensure achievement of the exempt purpose of the organization. Facts and circumstances which are considered in determining whether a partnership arrangement sufficiently insulates a section 501(c)(3) organization, as general partner, from any conflict between its partnership obligations and its exempt goals include: 1) nominal capital contribution by the exempt organization;\footnote{67} 2) limited contractual liability for the exempt organization;\footnote{68} 3) reasonable return on capital for the limited partners;\footnote{69} and 4) the right of first refusal for the

\footnote{63} See Comment, \textit{supra} note 34, at 1370.
\footnote{64} 74 T.C. at 1324.
\footnote{65} Comment, \textit{supra} note 34, at 1369, 1370. \textit{See also} I.R.S. Priv. Letter Rul. 83-42001.
\footnote{66} \textit{Plumstead Theatre}, 74 T.C. at 1334.
\footnote{67} I.R.S. Priv. Letter Rul. 83-38127, 83-44099; Gen. Counsel's Mem. 39005. Presumably the IRS is reasoning that when there is minimal capital appreciation, the organization's conflict between its projected pecuniary return and its obligation to serve the charitable class is minimized. Purcell & Yanowitz, \textit{supra} note 34, at 212.
\footnote{68} This may be easily provided by a non-recourse deed of trust. Presumably, the service wanted to insulate the exempt organization's resources from being applied to protect private investor's capital. I.R.S. Priv. Letter Rul. 83-38127; Gen. Counsel's Mem. 39005; Purcell & Yanowitz, \textit{supra} note 34, at 217.
\footnote{69} This is aimed at insuring that the private benefit will be incidental in comparison to the public purpose served. Average return on capital invested should range from about 6-8%. 

\textbf{1986} [LOW-INCOME HOUSING 473}
tax exempt partner.  

3. Unrelated Income

A final restriction imposed by the Service on tax exempt general partners in limited partnership arrangements concerns unrelated income. If a section 501(c)(3) organization receives income from any trade or business regularly carried on by that organization, the conduct of which is not "substantially related" to the charitable purpose of the organization, then such income is taxable unrelated business income.  

This issue often arises when a tax exempt general partner receives compensation for its administrative duties, and in the case of low-income real estate syndications, when a tax exempt charity enters into management contracts to oversee the daily maintenance and occupancy of the housing units. When such compensation is "reasonable" and "contributes importantly" to the accomplishment of the charitable group's exempt purpose, these partnership activities have been found to be "substantially related." Certain benefits will undoubtedly flow to an entity providing management services for a real estate syndication, but under a rationale similar to section 501(c) standards, such arrangements have been approved.

In sum, for a tax exempt charity to act as a general partner in a...
limited partnership real estate syndication, the partnership agreement must be narrowly tailored and include sufficient safeguards to demonstrate to the Service, if necessary, that the partnership will be organized and operated to further charitable purposes. Furthermore, the charity must be sufficiently insulated to prevent conflicts of interest which result in prohibited or private benefits inuring to parties other than the charitable class and from unrelated income inuring to the charity itself.

After the Plumstead Theatre case, the stage was set for a new era of creative private sector involvement in low-cost public housing through the medium of charitable organizations. If done properly, the use of such a vehicle to finance subsidized housing may increase the already scarce supply of decent, safe and sanitary low-income housing while simultaneously sheltering individual income. In addition, such efforts may stem the tide of conversion of existing low-cost rental property which further depletes the pool of low-cost shelter.\footnote{75} Involvement of this sort by charities would be consistent with the role of the private sector in the emerging new federalism;\footnote{76} however, perceived abuses in the transfer of tax benefits through tax exempt nonprofit groups has led Congress to enact sweeping and more restrictive tax exempt entity leasing provisions in the 1984 Act.\footnote{77}

IV. TAX EXEMPT ENTITY LEASING RESTRICTIONS

A. Perceived Abuses

Because of budget cutbacks in the late 1970s and early 1980s, many tax exempt entities used "privatization"\footnote{78} to finance projects that might otherwise have been cancelled or delayed. Privatization has been described as "private sector (i.e., a taxable entity) ownership and/or operation of property that has traditionally been owned and/or operated by the public sector (i.e., a tax exempt entity such...}
as a municipality, county, state or charity)." Because tax exempt entities are generally precluded from the benefit of accelerated depreciation and ITC when depreciable property is owned or operated by such entities, privatization, which shifts the ownership and/or operation of the property from the public to private sector, makes available tax benefits which otherwise would not exist. Through sophisticated leasing, partnerships, and other arrangements, the private sector was able to utilize these additional tax incentives, and thereafter pass through the benefits back to the tax exempt entities.

For example, before the 1984 Act, a tax exempt entity would enter into a service contract with a taxable entity whereby the taxable entity both provided and serviced a product for the beneficial use of the tax exempt entity. Because the taxable entity retained ownership of the product, it could utilize the ACRS deduction and ITC credit and subsequently pass through the tax benefit to the tax exempt entity in the form of reduced charges. Similarly, if a taxable entity leased property to a tax exempt entity, the tax benefits of ownership, other than ITC, would be passed through to the tax exempt entity in the form of reduced charges.

The most prevalent and scrutinized of these pass-through transactions were the lease-purchase agreements and the sale-leaseback arrangements with municipalities, state and federal government

79. "Privatization is a method of financing a tax exempt entity's (e.g., county, municipality, charity) capital project by taking advantage of tax incentives available only to the private sector." Warren, Leases and Service Contracts with Tax Exempt Entities After the DRA, TAX ADVISER, April 1985, at 230.

80. By definition, a tax exempt organization generally pays no taxes from which a depreciation expense may be deducted or against which an ITC may be credited. In addition, ITC was, and still is, disallowed for property used by a tax exempt entity. See I.R.C. § 48(a)(4) and (5). See also I.R.C. § 48(g).

81. In the case Xerox Corp. v. United States, 656 F.2d 659 (1981), machines used by a branch of the federal government were entitled to investment credit status because they were not leased but supplied as an integral part of a service arrangement. See infra notes 125-28 and accompanying text.

82. Warren, supra note 79, at 231.

83. See supra note 80.

84. Lease purchase agreements are essentially installment sales contracts providing for the acquisition of property by a governmental entity. Under the contract, the governmental entity makes periodic payments representing installments of the purchase price of the property plus interest. At the end of the contract term, the government will own the property or will acquire it for a nominal sum. See Cong. Budget Office, Trends in Municipal Leasing 176, 179 (1983) (report prepared for Subcommittee on Oversight of House Ways and Means Comm.) [hereinafter cited as MUNICIPAL LEASING].

85. Sale leaseback agreements make it possible for local governments and other nontaxable entities to benefit from tax deductions normally available only to the private sector. Under these agreements, a local government or a tax exempt institution sells real property to private
entities. The growth and innovations in tax exempt entity leasing made it possible to circumvent the budget process and to benefit non-taxable entities from tax deductions available only to the private sector. In order to prevent windfall benefits from falling upon underserving tax exempt entities and to prevent large losses of revenue incident to such "double dipping" and other "use" arrangements, Congress promulgated the tax exempt entity leasing provisions.

B. Legislative Response

The tax exempt entity leasing provisions directly attack those sophisticated leasing, partnership and other arrangements which provide benefits to non-taxable entities from private sector tax deductions. The legislative enactments are broad, far-reaching and almost certain to stem the flow of pass-through tax benefits to non-taxable entities; however, the legislation is too broad, and in places, too imprecise. It is likely that these provisions will have a chilling investors and simultaneously leases it back. The private entity puts equity into the property and in return gets rental payments and the tax benefits of ownership, which include interest deductions, depreciation deductions, and occasionally, investment tax credit. These tax benefits are generous and can be passed on to the lessee in the form of lower rental payments. Sale leasebacks works for all manner of facilities, from college campuses to city halls, and their use was growing. Id. at 177.

86. See id. at 177-78. Such uses include: a $54 million lease financing for new parking facilities in Anaheim, Cal. and a $34 million lease financing to fund a telephone system for San Diego County, Cal. Id. at 180. Under such an arrangement, a private college arranged to sell and lease back its 650 acre campus from a private investor. Id. at 184.

87. Treasury Fact Sheet, Tax Exempt Leasing, FED. TAX. REP. (CCH) ¶ 6161 (Feb. 9, 1984). Even the U.S. Navy used such practices to fund the construction of ships for the Rapid Development Force. See JOINT COMM. ON TAXATION, 90TH CONG., 1ST SESS., TAX ASPECTS OF FEDERAL LEASING ARRANGEMENTS (Joint Comm. Print 1983).

88. See MUNICIPAL LEASING, supra note 84, at 177. "Potentially, however, they may be a vehicle both for off-budget revenue sharing with local governments and for providing subsidies to nontaxable institutions." Id. at 185.

89. "Double dipping" occurs when more than one component of a transaction is exempt from taxation. For example, when property financed by tax exempt bonds is leased to a tax exempt entity, "double dipping" results in large losses of revenue to the federal treasury. Pending Legislation, Tax Exempt Entity Leasing, 3 STAND. FED. TAX'N REP. ¶ 6161 (Feb. 9, 1984).

90. H.R. REP. NO. 432, Part I, 98th Cong., 2d Sess., 64-65 (1984). The House committee cited additional reasons, beyond revenue loss, for eliminating such benefits including accountability, waste and the need for controlled appropriations rather than open-ended tax benefits. Of special concern was the fact that only a proportion of those funds, of which the federal revenue was deprived, were passed through to the tax exempt entity, while private investors enjoyed the remainder. Under such circumstances, direct appropriations are more cost effective.

effect on the participation of tax exempt charities in low-income construction and rehabilitation projects.

The relevant portions\textsuperscript{92} of the Act restrict the deduction available for depreciation of eighteen-year real property\textsuperscript{93} and low-income housing\textsuperscript{94} to a straight line method over a recovery period of forty years if such property is “tax exempt use property.”\textsuperscript{95} The loss of ACRS would result in drastically lower depreciation deductions for the first years the property is owned, and an investor would be able to shelter much less of his immediate personal income from federal income taxes.\textsuperscript{96} In addition, if property is determined to be “tax exempt use property,” ITCs could also be disallowed.\textsuperscript{97} To an investor in a limited partnership, the potential loss of these tax benefits could dissuade him from investing in any syndication which might involve tax exempt use property.

As defined in the Code, tax exempt use property includes any depreciable property that is leased to,\textsuperscript{98} used by,\textsuperscript{99} or partially owned\textsuperscript{100} by a tax exempt entity.\textsuperscript{101} Property that is leased to a tax

\textsuperscript{92}This analysis of the Tax Exempt Entity Leasing provisions of the 1984 Act is narrowly limited to the subject matter of this comment; i.e., the role of tax exempt entities in the syndication of long term low-income housing. For a more broad and encompassing treatment of the 1984 Act on all real estate investments, see Sanders & Roady, \textit{How the New Tax Law Changes the Operating Rules for Real Estate Investments,} 62 J. TAX'N 22 (1985).

\textsuperscript{93}I.R.C.\textsuperscript{\&}§ 168(c)(2)(D) “18 year real property is a class of recovery property; i.e., tangible property of a character subject to allowance for depreciation as provided in § 167”. I.R.C. §§ 168(a), (c)(1), (c)(2)(D), and I.R.C. § 1250(c).

\textsuperscript{94}Low-income housing, as used in this section, is defined in I.R.C. § 1250(a)(1)(B) and includes: 1) property financed in part pursuant to I.R.C. § 221(d)(3) or I.R.C. § 236 of the National Housing Act; 2) property held for occupancy by persons eligible under § 8 of the United States Housing Act of 1937; 3) housing-allowed depreciation deductions for rehabilitation expenditures pursuant to I.R.C. § 167(k); and 4) property financed in part under Title V of the Housing Act of 1949. I.R.C. § 168(d)(2)(F).

\textsuperscript{95}Whereas the ACRS 18-year property and low-income housing enjoyed the benefits of 18-year and 15-year recovery periods respectively, when such property is “tax exempt use property,” the depreciation deductions are spread out over a recovery period of at least 40 but not less than 125\% of the lease term. In addition, the rate at which the depreciation deductions are allowed is reduced from 175\% or 200\% of the declining balance method for 18-year property and low-income housing respectively to a slower straight line method. See I.R.C. § 168(j)(1)(2). See also I.R.C. § 168(b)(2) and (4). For definitions of the methods used to determine the rate of allowed depreciation deductions, see I.R.C. § 167(b).

\textsuperscript{96}Income is sheltered, in part, by offsetting or reducing the total amount of taxable income by allowable expenses and depreciation deductions. Accelerated depreciation allows greater amounts of income to be sheltered immediately. The benefit to the taxpayer is not tax forgiveness, but tax deferral. Given the time value of money, such tax deferral is of substantial benefit to the taxpayer.

\textsuperscript{97}I.R.C. § 168(j)(8), (9).

\textsuperscript{98}I.R.C. §§ 168(j)(3)(A), 168(j)(8).

\textsuperscript{99}I.R.C. § 7701(e), 168(j)(3) and (6).

\textsuperscript{100}I.R.C. § 168(j)(9).
exempt entity in a disqualified lease and property that is leased to a partnership with a tax exempt entity constitutes tax exempt use property. In addition, if property is used by a tax exempt entity pursuant to a service contract, such use may be recharacterized as a lease for a tax exempt entity and thereby qualify as tax exempt use property. Because tax exempt entities rarely, if ever, would have

101. For the purposes of I.R.C. § 168, a tax exempt entity includes any governmental entity, foreign persons or entities and other entities exempt from tax pursuant to I.R.C. § 501(c), (d). I.R.C. § 168(j)(4)(A).

102. A disqualified lease includes any lease to a tax exempt entity which contains any of the following conditions or characteristics: 1) the tax exempt entity participates in financing through the issuance of tax exempt obligations under I.R.C. § 103; 2) such lease contains a fixed or determinable purchase price or sale option which involves the tax exempt entity or related entity; 3) such lease has a lease term in excess of 20 years; or 4) such lease occurs after a sale or other transfer of the property by, or lease of the property from, such entity or a related entity which has already been using the property. I.R.C. § 168(j)(3)(B)(iii). At least 35% of such property must be leased to a tax exempt entity in a disqualified lease to constitute tax exempt use property. I.R.C. § 168(j)(3)(B)(iii). An organization "will be treated as having participated in a bond financing pursuant to § 169(j)(3)(B)(ii)(I) if, prior to the issuance of bonds, it commits to enter into a lease of all or part of the property after it has been acquired by the taxpayer" H.R. REP. No. 432 Part II, 98th Cong., 2d Sess. 1145, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 125. This provision will effectively eliminate "double dipping."

103. I.R.C. § 168(j)(8)(A). The tax exempt entity's proportionate share will be treated as leased to such partners and thereby constitute tax exempt use property. Id. The 35% threshold applicable when property is leased directly to a tax exempt entity would also apply here. Id. See also W. MCKEE, W. NELSON, & R. WHITMORE, Tax Reform Act of 1984: Provisions Affecting the Taxation of Partnerships and Partners, 43 INST. ON FED. TAX'N § 28.0214, at 28-4 (1985). In addition, rules similar to those in I.R.C. § 168(j)(8)(A) will apply to tiered partnerships and other pass through entities. I.R.C. § 168(j)(8)(B).

104. I.R.C. § 7701(e)(1). As codified in § 7701(e)(1), a service contract may be recharacterized as a lease if: 1) the service recipient (or lessee) is in physical possession of the property, controls the property, or has a significant economic or possessory interest in the property; and 2) the service provider (or lessor) does not bear any significant economic risk if there is nonperformance under the contract or does not use the property concurrently to provide services to entities unrelated to the service recipient; and 3) the total contract price does not substantially exceed the rental value of the property for the contract period. Id. Hence, a contract will be treated as a lease if, taking all factors into consideration, it more nearly resembles a lease; the presence or absence of any single factor may not be dispositive in any given case. H.R. REP. No. 432 Part II, 98th Cong., 2d Sess. 1154, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 828. For a more complete explanation of disqualified lease, see Warren, supra note 79, at 236-38.

Physical possession by the service recipient is indicative of a lease, yet the mere fact that such property is located on the premises of the service recipient is not dispositive. If it is operated by the employees of the service recipient, then such property is viewed as being in the possession of the recipient. H.R. REP. No., 432 Part II, 98th Cong., 2d Sess. 1153, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 827.

When a service recipient has a right to dictate the manner in which the property is operated, maintained or improved, such control is indicative of a lease. Id.

A significant economic or possessory interest, indicative of a lease, is established by facts which show that the property's use is likely to be dedicated to the service recipient for a
reasons to enter into these types of arrangements when syndicating low-income housing, attention should be directed to the real headache of the 1984 Act, the partnership allocation provision in section 168(j)(9).\textsuperscript{106}

Perhaps the most troublesome provisions of the 1984 Act affecting tax exempt charitable organizations in real estate syndications are those provisions which treat property owned by a partnership as tax exempt use property. Section 168(j)(9) provides that when a tax exempt entity receives a “non-qualified allocation” of partnership items,\textsuperscript{106} an amount equal to the tax exempt entity’s greatest proportional share of such property will be tax exempt use property.\textsuperscript{107} For an allocation to be qualified, it must: 1) be consistent with such entity’s being allocated the same distributive share of other partnership items; 2) remain the same during the entire period that the entity is substantial portion of the useful life of the property and the service recipient shares the risk that the property will be damaged, decline in value or appreciate in value. \textit{Id.}

The fact that the total contract price is principally based on the recovery of the cost of the property, and does not reflect the additional cost of the service, is indicative of a lease. \textit{Id.} at 828.

105. Because these types of leasing and service contract arrangements are generally not utilized in real estate syndications, they will pose little if any problem. Furthermore, tax exempt organizations operating low-income housing are specifically excluded from the recharacterization provisions of the service contract analysis. I.R.C. \textsection 7701(e)(5). However, the broad definition of “lease” in I.R.C. \textsection 168(j)(6) and the limited scope of the exclusion in I.R.C. \textsection 7701(e)(5) raise uncertainties and problems which will be discussed infra notes 122-23 and accompanying text.

106. In general, partnership items allocated between the individual partners include items of income, gain, loss, deductions and credits. The character of those partnership items is determined as if such item were incurred in the same manner as incurred by the partnership. I.R.C. \textsection 702. Because a partnership itself is not subject to income tax, the distributive share of each partner, as determined by the partnership agreement, is separately liable for income tax. I.R.C. \textsections 701, 702, 704. The distributive share, however, will only be determined by the partnership agreement when the various allocations of partnership items have substantial economic effects; i.e., if there is a reasonable possibility that the allocations will affect substantially the dollar amounts to be received by the partners, from the partnership, independent of tax consequences. Treas. Reg. \textsection 1.704-1(h)(iii) (CCH 1985). In general, the allocation of partnership items may be structured to meet the requirements of I.R.C. \textsection 704(b)(2) if: 1) the allocations are reflected as an increase or decrease in each respective partner’s capital account, 2) liquidation proceeds are distributed in accordance with their capital accounts, and 3) individual partners remain obligated to restore to the partnership any deficit in their capital account. Treas. Reg. \textsection 1.704-1(b)(2) (CCH 1985). Problems of inordinate complexity are raised when the partnership invests in real property subject to nonrecourse liability, as the case would be here; nevertheless, these problems are beyond the scope of this comment. Hereinafter this comment will assume that the partnership allocations have substantial economic effect.

107. I.R.C. \textsection 168(j)(9)(A) and (C). When property is used by the tax exempt entity in an unrelated trade or business (see \textit{supra} notes 71-74 and accompanying text) then pursuant to I.R.C. \textsection 168(j)(3)(D) such property will not be characterized as tax exempt use property. \textit{Id.} The 35% threshold applicable when property is leased, directly or indirectly, to a tax exempt entity, does not apply to these partnership allocation provisions. \textit{See infra} note 113.
a partner in the partnership; and 3) have substantial economic effect pursuant to 704(b)(2).\textsuperscript{108} The third element requiring substantial economic effect of the qualified allocation does not impose any additional burden or present any immediate problems for a tax exempt entity in a limited partnership;\textsuperscript{109} however, the first two restrictions may have a very chilling effect on the participation of charitable organizations in real estate syndications.

C. Restrictive Effect on Tax Exempt Charitable Organizations

1. Partnership Provisions

Real estate syndications and tax exempt partnerships are directly affected by the partnership provisions of the tax exempt entity leasing provisions. In particular, section 168(j)(9), which characterizes property owned by a partnership as tax exempt use property, will affect most syndications of low-income housing which include a tax exempt entity as a partner. For example, consider the earlier illustration of a typical low-income housing syndication, when E, the tax exempt general partner, has a minimal one percent interest in operating income and loss, but upon liquidation, a substantial (fifty percent, for example) interest in the residual proceeds upon liquidation of the partnership asset, i.e., H, the low-income housing project. Assume further that E will receive a special allocation whereby his distributive share of partnership income and/or gain increases from one percent to twenty percent during the course of the partnership.\textsuperscript{110} Assuming that such allocations have substantial economic ef-

\textsuperscript{108} I.R.C. § 168(j)(9)(B). Allocations resulting from contributions of property pursuant to I.R.C. § 709(c) will not be taken into account. Id.

\textsuperscript{109} As discussed supra note 106, partnership allocations may be structured in this partnership agreement to meet the requirements of I.R.C. § 704(b)(2) and for the purposes of this comment, the allocations will be assumed to have substantial economic effect. Nevertheless, it is important to point out that the new regulations, similar in most respects to the proposed regulations, under I.R.C. § 704(b)(2) will significantly affect the structure of future real estate syndications. See generally Charyk, An Overview of the Proposed Section 704 Partnership Allocation Regulations-Implications for Real Estate Partnerships, 1983 J. OF REAL ESTATE TAX'N 34. See also Pehell, Final Partnership Allocation Regs. Will Have Significant Impact, 64 J. TAX'N 188 (1986).

\textsuperscript{110} Such a special allocation, commonly referred to as a “flip,” will typically be structured to occur when the limited partners have been allocated an amount of partnership income and gain equal to their original capital contribution. These allocations will, in effect, build up the tax exempt limited partner’s capital account so that substantial liquidation proceeds may be allocated to him, despite minimal capital contributions at the outset, and such allocations will have substantial economic effect within the meaning of I.R.C. § 704(b)(2). Again, transitory allocations must be carefully scrutinized in light of the new regulations under I.R.C. § 704(b)(2). See supra note 109.
fect, then with regard to the special allocation, at least twenty percent of the partnership property would be considered the tax exempt use property. Clearly, E would be neither receiving the same distributive share of partnership items, nor would E’s share remain the same during the period of the partnership. Accordingly, twenty percent of the partnership property would lose the benefits of ACRS; thus, the investment incentives for potential limited partners is reduced.

In sum, it seems that all special and other inconsistent distributions of partnership items during the course of the partnership will be considered nonqualified allocations. The question remains unresolved, however, whether a “rear-end” allocation of liquidation proceeds will constitute nonqualified allocations. Again, referring back to the model illustration in which E, the tax exempt limited partner, was allocated a fifty percent interest in the liquidation proceeds, a broad interpretation of the partnership provision would consider a fifty percent allocation to be nonqualified, and fifty percent of the partnership property would be tax exempt use property. With a fifty percent loss of ACRS on the partnership property, the limited partners would be able to shelter much less of their personal incomes. Such a disincentive would severely diminish the attractiveness of the investment and have a chilling effect on the participation of charitable organizations in the low-income real estate investments of the private sector. Alternatively, if the partnership agreement were structured to eliminate this rear-end allocation to the tax exempt limited partner, then the charitable organization’s control over the future disposition of the project would be severely reduced.

Many experts believed that the IRS would enact regulations to give the tax exempt entity leasing provisions such a broad interpretation; however, the temporary regulations the IRS issued July 2, 1985 seem to indicate that such inconsistent distribution of liquidation proceeds will not cause the allocation to be nonqualified. In

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111. See supra note 109.
112. I.R.C. § 168(j)(9)(A), (B), (C).
113. I.R.C. § 168(j)(9)(B)(i). Similarly, even if there were no flip so that throughout the entire period of the partnership, E received 1% of the items of income, loss, deductions and credit, but 20% of partnership gain, 20% of the property would still be considered tax exempt use property. Id. See also W. McKee, W. Nelson, & W. Whitmore, supra note 103, § 28.02[5] at 28-7; Treas. Reg. § 1.168, Q-A 22, example 2 (proposed July 2, 1985).
114. See I.R.C. § 168(j)(1).
115. See Sanders & Roady, supra note at 92, at 24; see also Power, supra note 47, at 13.
sum, if the temporary regulations are adopted in their present form, the basic structure of the limited partnership, which allows both the private sector and charitable tax exempt entities to contribute to the supply of long term low-income housing, will survive the axe of tax reform. Nevertheless, the structure of the limited partnership will be directly affected by the tax exempt entity leasing provisions, and the uncertainties generated therefrom will have a chilling effect on the participation of tax exempt charitable organizations.

2. Disqualified "Lease" Provisions

In contrast to the direct effect the partnership provisions will have on the participation of tax exempt entities in real estate syndications, the "disqualified lease" provisions may only indirectly affect a real estate syndication with a tax exempt charitable organiza-

entity, and B, a tax-exempt entity, form a partnership in 1985. A contributes $800,000 to the partnership; B contributes $200,000. The partnership agreement allocated 95% of each item of income, gain, loss, deduction, credit, and basis to A; B's share of each of these items is 5%. Liquidation proceeds are throughout the terms of the partnership to be distributed in accordance with the partner's capital account balances, and any partner with a deficit in his capital account following the distribution of liquidation proceeds is required to restore the amount of such deficit to the partnership. Assuming that these allocations have substantial economic effect within the meaning of I.R.C. § 704(b)(2), they are qualified because B's distributive share of each item of income, gain, loss, deduction, credit, and basis will remain the same during the entire period that B is a partner. The fact that the liquidation proceeds may be distributed in a ratio other than 95% to 5% does not cause the allocations not to be qualified.

Thus, if these temporary regulations are enacted in their present form, the rear-end allocations of liquidation proceeds would clearly be qualified providing they have substantial economic effect within the meaning of § 704(b)(2). See generally Yanowitz & Purcell, Analysis of the Just-Issued Temporary Regulations on Tax Exempt Entity Leasing, 63 J. TAX'N 112 (1985).

117. Until final regulations are enacted, pursuant to § I.R.C. 168(j)(10), these arrangements will still remain somewhat uncertain. Even if the temporary regulations are enacted, it is important to point out that these unique partnership arrangements will not escape the 1984 Act unscathed. For instance, the limitations imposed upon special or inconsistent allocations might make it difficult to distribute liquidation proceeds in accordance with the tax exempt partner's capital account, and without substantial economic effect such allocations would be nonqualified. I.R.C. § 168(j)(9)(b)(ii). It may be possible to plan around these difficulties by including in the limited partnership vehicle a taxable nonprofit subsidiary to act as a general partner in the syndication; being taxable, the nonprofit subsidiary might be able to receive unqualified allocations without the adverse consequences of tax exempt use property. See Power, supra note 47, at 13. Nevertheless, there remain many uncertainties with this approach; the taxable subsidiary may be treated as a related entity (I.R.C. § 168(j)(7)) or other entity (I.R.C. § 168(j)(9)(D)) and be subject to the same treatment as a tax exempt entity. Furthermore, changes proposed by the Technical Correction Act of 1985 might consider such a taxable subsidiary to be the successor organization of a tax exempt entity, and thereby subject to the same treatment as the parent tax exempt entity. H.R. 1800, 99th Cong., 1st Sess., 131 CONG. REC. H1631 (1985).

118. See supra note 102 and accompanying text.
tion. As defined under section 168(j) of the Code, a disqualified lease will lead to a determination of tax exempt use property when such property is leased to a tax exempt entity or a partnership with a tax exempt entity. Because a real estate syndication would rarely, if ever, choose to lease depreciable property, it seems unlikely that these provisions would have an adverse impact on the participation of charitable organizations. Nevertheless, if the Service finds that there exists a lease to a tax exempt entity, it is likely that such a lease would be disqualified and would result in a determination of tax exempt use property.

The problems and uncertainties associated with the disqualified lease provisions can be attributed, in large part, to the broad definition given to the term "lease" which includes "any grant of a right to use property." Although this broad definition is not explicit in section 168(j)(9) of the Code, other statutory provisions and examples in the legislative history demonstrate the expansive definition given to this "lease" in the context of service contracts, management contracts and other arrangements.

a. Service Contracts and Other Arrangements

As discussed above, service contracts have been used to transfer the use and possession of property to tax exempt entities without

119. See I.R.C. § 168(j)(3) and (8) (CCH-1984).
120. When depreciable property is not owned by a partnership, individual or other entity, but rather leased to such entity, then that entity is not entitled to take depreciation deductions on the property so leased. This would obviate the primary motivation of most limited partners in real estate syndications.
121. Three of the four tests outlined in note 102, any one of which would disqualify a lease to a tax exempt entity, would likely be triggered as follows: 1) Because of the drastic reduction in the amount of federal funds available for low-income housing, syndicators are turning to state and municipal agencies which derive their funding, in large part, from tax exempt bonds. See D. SMITH, supra note 24, at 5. Such tax exempt financing would disqualify a "lease." I.R.C. § 168(j)(3)(B)(ii)(I)(2). If the tax exempt entity negotiated an option or right of first refusal at a fixed or determinable price, as discussed supra note 102, then any such "lease" would be disqualified, I.R.C. § 168(j)(3)(B)(ii)(II); 3) If such "lease" occurred after a sale or other transfer by a tax exempt entity, similar to the original sale contemplated in the illustration discussed at note 48 and accompanying text, then the "lease" would be disqualified. I.R.C. § 168(j)(3)(B)(ii)(III).
122. I.R.C. § 168(j)(6)(A). In its broadest sense, a partnership which allowed a charitable general partner to control and limit the use of the partnership property for low-income housing might constitute a "grant of a right to use property", i.e., a lease. However fantastic as this seems, the partnership provisions parallel this interpretation and find tax exempt use property in those nonqualified allocations to tax exempt partners.
123. As discussed in note 122, the broad definition is implicit in the partnership provisions, especially as the partnership provisions are applied to tiered partnerships and any other pass through entities. I.R.C. § 168(j)(9)(D).
sacrificing the transferor's investment tax credits.124 Until the 1984 Act, the characterization of such arrangements as either a lease or service contract was controlled by case law, revenue rulings and private letter rulings.126 The analysis emerging from those cases focused on who enjoyed the benefits and who bore the burdens of ownership.128 As codified in section 7701(e),127 a contract will be treated as a lease if, taking all factors into consideration, it more nearly resembles a lease.128

These restrictions on service contracts will not, for the most part, affect tax exempt charities in real estate syndications because these service contracts are generally not integral to their partnership agreements. Nevertheless, other provisions of the Act require that this same "benefits and burdens" analysis be applied to partnerships and other pass-through entities to determine whether or not such other arrangements are more properly treated as a lease.129 For example, when a not-for-profit hospital and a partnership composed of members of the hospital's medical staff entered into a joint venture to acquire and operate a computer axial tomography (or "CAT") scanner, the arrangement was treated as conveying a leasehold estate between the parties.130 Even though the arrangement was classified as a partnership with qualified allocations and substantial economic effect between the partners, because the not-for-profit hospital receives the majority of the benefits and burdens of ownership, the CAT scanner becomes tax exempt use property.131 Thus, the essence of the partnership, the common ownership interest in partnership property, has been recharacterized and recast into a leasehold interest for tax purposes.

In this particular example, it is not too difficult to apply the

124. See supra text accompanying notes 81-88.


126. The benefits of ownership are possession and control. Xerox Corp., 656 F.2d at 671-76. The burdens of ownership are suffering the risks of loss and responsibility for maintenance and repair of the property. Id. at 671-73. The legislative history of the bill makes clear that service contract arrangements may be characterized as a lease when "property is used to provide services to or for the benefit of a tax exempt entity." H.R. REP. No. 432 Part II, 98th Cong., 2d Sess. 1153, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 783.

127. See supra note 104.


131. Id.
relevant factors of the service contract analysis; however, in the context of a real estate syndication with a tax exempt charity acting as general partner, the application of the benefits and burdens analysis is more complex.\textsuperscript{132} For this and other reasons,\textsuperscript{138} Congress excluded section 501(c)(3) and 501(c)(4) organizations who operate low-income residential property from the service contract and other arrangement rules.\textsuperscript{134} The legislative history of the Act makes it clear that a charitable organization "is not subject to the service contract or other arrangements of the bill;"\textsuperscript{138} therefore, the "leasing of units of such property to occupants is not treated as use by or on behalf of such an organization."\textsuperscript{136}

Even though service contracts are rarely, if ever, entered into between taxable and tax exempt entities syndicating real estate, the exclusion will effectively eliminate any complex analyses which might arise from the "other arrangement" provisions of the Act.\textsuperscript{137} Nevertheless, this exclusion for charitable organizations is very narrow and raises more uncertainties than it resolves.\textsuperscript{138}

\textsuperscript{132} It is unclear who is providing and who is receiving what services. Certainly a tax exempt general partner is providing administrative and managerial services; yet, at the same time, the taxable limited partners are providing financing and other valuable services. Furthermore, while the tax exempt general partner may be receiving an indirect benefit by providing affordable housing to low-income tenants, the limited partners are also receiving benefits from their tax sheltered real estate investments. Thus, the exclusion from these restrictions in I.R.C. § 7701(e)(5) seems both logical and necessary.

\textsuperscript{133} The exception for 501(c)(3) organizations operating low-income housing, I.R.C. § 7701(e)(5), is very narrow. Interview with Michael G. Smith, Attorney with the National Housing Law Project at Berkeley, Cal. (Oct. 15, 1984).

\textsuperscript{134} I.R.C. § 7701(e)(5) (CCH-1984). At least 80% of the units of such property must be leased to low-income tenants as defined in I.R.C. § 167(k)(3)(B), and the tax exempt organization must be described in either I.R.C. § 501(c)(3) or (4).

\textsuperscript{135} H. CON. REP. No. 861, 98th Cong., 2d Sess. 790, \textit{reprinted} in 1984 U.S. CODE CONG. & AD. NEWS 784. Even though the legislative history literally applies the exclusion to "other arrangements of the bill," I.R.C. § 7701(e)(5) limits the exclusion to "this subsection," i.e., I.R.C. § 7701(e). Such use of language in the legislative history is not dispositive in determining the ambit of I.R.C. § 7701(e)(5), but rather it raises certain questions. In particular, did Congress intend to exclude the same charitable organizations from the other arrangements in the partnership provisions (I.R.C. § 168(j)(9)(D)), from the broad definition of "lease" (I.R.C. § 168(j)(6)), or from the related entity or successor provisions (I.R.C. § 168(j)(4)(E)(iii) and § 168(j)(7))? Conversely, did Congress intend that the "leasing of such units" to low-income tenants constitute a "grant of right to use" property per 168(j)(6)?


\textsuperscript{137} See I.R.C. § 7701(e)(2).

\textsuperscript{138} See supra note 135. The temporary regulations issued July 2, 1985 further indicate that this exclusion will be narrowly interpreted. Treas. Reg. § 1.168-1T, T.D. 8033, 50 Fed. Reg. 27,228 (1985). For example:

Q-19. Does a contract to provide heating, maintenance, etc. services in low-income housing come within the low-income housing exception in I.R.C. §
b. Management Contracts

A final uncertain and potentially chilling effect on the participation of tax exempt entities in real estate syndications lies in the broad application of the tax exempt leasing legislation to management contracts. Tax exempt organizations, which commonly contracted with private syndications to manage low-income housing developments, now must take special care to avoid such contracts being treated as a lease. The legislative history of the bill leaves open the possibility that even though a management contract might not be treated as a lease under the service contract provisions, such a management contract may well be treated as a lease under "present law rules." The legislative history points to two cases from which the test factors under the present law rules have been derived. The legislative history also lists three factors which, if met, would recharacterize a management contract as a lease. These are: 1) whether the taxpayer does not adequately control the property; 2) whether the taxpayer does not bear the risk of loss; and 3) whether the tax exempt entity provides services to third parties for its "own benefit."

Of these three factors, only the first two are clearly derived from the McNabb and Meagher cases. The third factor seems to

7701(e)(5) to the service contract rules set forth in I.R.C. § 7701(e)?
A-19. No. Although certain low-income housing operated by or for an organization described in paragraphs (3) or (4) of I.R.C. § 503(c) is not subject to the service contract rules in I.R.C. § 7701(d), a contract, for instance, to provide heating services to low-income housing units, such as by installing and operating a furnace, does not constitute "low-income housing" within the meaning of I.R.C. § 7701(e)(5). Thus, the rules of I.R.C. § 7701(e) apply to such contracts in determining whether they are properly treated as leases.

Id.

139. For instance, in the legislative history there is an example involving a real estate syndication of low-income housing when the tax exempt entity, a municipal housing authority, enters into a long term management contract. See H.R. REP. NO. 432 Part II, 98th Cong., 2nd Sess, 1155-56, reprinted in 1984 U.S. CODE CONG. & AD. NEWS 136.


141. Id.; McNabb v. Commissioner, 81-1 USTC 86, 156 [47 AFTR 2d 81-513] (W.D. Wash. 1980); Meagher v. Commissioner, 36 T.C.M. 1091 [1977 P-H T.C. Memo ¶ 77, 270] (1977); see also Americo v. Commissioner, 82 T.C. 654 (1984). In the McNabb and Meagher cases, the courts closely examined the contractual arrangements between the parties to determine whether they were indicative of a principal-agent or lessor-lessee relationship.


143. McNabb, 81-1 USTC at 86,156-57; Meagher, 36 T.C.M. at 1091-93; Americo, at 654, 674. These cases cited an additional factor pointing toward the existence of a management contract which the legislative history overlooks; if the service provider uses his "best efforts" to
introduce a new element into the present law rules for analyzing management contracts which is similar to the service contract analysis. In particular, the present law rules, as set out in Meagher and McNabb, make no direct reference to personal “benefit” when distinguishing leases from management contracts. In contrast, the service contract analysis closely examines the economic benefits and burdens of ownership.

What exactly is meant by “benefit” in this context is uncertain, and whether the Internal Revenue Service will try to inject this new element into the management contract analysis is equally uncertain. What is certain is that the Service has already challenged many of these management contracts, treating as unrelated income any compensation which results in more than an incidental benefit to the tax exempt organization. It seems, therefore, that the new element injected into the management contract analysis is not only vague and uncertain, but also redundant and possibly even unintended. Nonetheless, special care must be taken to comply with the present law rules and to avoid the disqualified lease provisions of the 1984 Act.

In conclusion, the tax exempt entity leasing provisions of the
1984 Act will both directly and indirectly affect the participation of tax exempt entities in real estate syndications. The partnership provisions of the Act will directly affect the structure of the partnership distributions and allocations. The disqualified lease provisions will indirectly affect such tax exempt entities by requiring additional planning and caution to structure low income real estate syndications. The exclusion for low-income housing, operated by or for charitable organizations, will eliminate some of the problems, yet the uncertainties raised by the broad definition of "lease" and the new management contract analysis further complicate the planning process. These uncertainties and complexities are likely to have a chilling effect upon the participation of tax exempt charities in real estate syndications.

V. PROPOSED SOLUTIONS

Although the Act will adversely affect, in varying degrees, almost every community development project that relies on federal income tax incentives, only in rare cases will whole projects become unfeasible. Instead, private investors will be able to circumscribe those new provisions which are clear and comprehensible through careful drafting and organization; however, those more ambiguous and complex provisions will force investors and syndicators to "squeeze out" tax exempt organizations from their syndications for fear of losing tax incentives. Until these complicated and uncertain provisions are addressed by final regulations, new legislation, or case law, the goal of maintaining an adequate supply of low-income housing will remain unrealized.

To resolve these legislative shortcomings, it is important to keep in mind the intent of the legislation—to prevent the pass-through of tax incentives from taxable to non-taxable entities. Municipal leasing practices, for example, allowed a municipality to enjoy both the benefits of ownership through a sale leaseback transaction and also the pass-through tax benefits of ACRS and tax exempt bond financing. In contrast, the tax exempt entity in the model illustra-

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148. As discussed supra note 117 and accompanying text, certain planning strategies may successfully protect a project from the tax exempt entity leasing provisions; however, there are many hidden pitfalls and traps. The temporary regulations have indicated that the Service will issue letter rulings on "qualified allocations" but not on whether the allocation has substantial economic effect. Treas. Reg. § 1.168-1T, (Q-A 24), T.D. 8033, 50 Fed. Reg. 27,228 (1985).

149. See supra notes 84-90 and accompanying text.

150. Id.
tion of a low-income syndication cannot directly enjoy the benefits of ownership. The restrictions and limitations of section 501(c)(3) require that the private benefit accruing to the tax exempt entity be incidental compared to the public benefit. Furthermore, the fiduciary duty owed by the tax exempt general partner to the taxable limited partners further restricts the tax exempt entity’s use and enjoyment of the property. It is true that the tax exempt charity is able to utilize certain pass-through tax benefits to promote its charitable end, but many of these tax incentives have already been sanctioned and accepted by the Congress. Furthermore, any prohibited tax benefit which might be realized by a tax exempt entity is directly passed back through to the charitable class, i.e., those people qualified to rent low-income housing.

To further demonstrate the unsoundness of the present statutory scheme, it is important to compare the benefits to the public and the burdens on the federal treasury in real estate syndications which do and do not include tax exempt entities. Before the 1984 Act, both types of syndications were able to take advantage of ACRS and other tax incentives during the period of the partnership. After termination of the partnership, however, a charitable general partner could control the future disposition of the property and preserve its use for the benefit of low-income tenants. In contrast, a syndication without a charitable general partner would be free to resyndicate and convert the property to a more profitable use after the HUD restrictions and tax incentives lapsed. Given the incidental amount of income a section 501(c)(3) organization is permitted to accrue, the minimal loss of tax revenue to the government, and the tremendous need for long term low-income housing, a broad exclusion for charitable organizations providing low-income housing is soundly justified.

In order to exclude tax exempt charitable organizations from the restrictive provisions of the tax exempt entity leasing rules, an exclusion similar to that in section 7701(c)(5) should be included directly in subsection 168(j) of the Code. Like the other exclusions

151. See supra note 48 and accompanying text.
152. See supra note 69 and accompanying text.
153. See supra note 62 and accompanying text.
154. See, e.g., I.R.C. § 167(k); § 168(b)(4); §48(g)(2)(D).
155. See supra note 49 and accompanying text.
156. See supra notes 30-32 and accompanying text.
157. Such an exclusion might read: “This subsection shall not apply to any low-income housing (within the meaning of I.R.C. § 168(c)(2)(F)) if: 1) such property is operated by or for an organization described in paragraph (3) or (4) of § I.R.C. 501(c), and 2) at least 80% of the units in such property are leased to low-income tenants (within the meaning of I.R.C. §
in subsection 168(j), such charitable organizations would escape both the restrictive partnership provisions and the broad “lease” disqualifications. This would further insulate a charitable organization from the indirect consequences of both the service contract and management contract analyses. In effect, this type of broad exclusion would allow tax exempt charities to participate in low-income real estate syndications as before the tax exempt entity leasing provisions of the 1984 Act.

If the intent of Congress was to limit the participation of tax exempt charities in providing low-income housing, then legislative steps must be taken to clarify how, and at what cost, tax exempt organizations might participate in real estate syndications to assist them in achieving their tax exempt goals. In particular, the uncertainties raised by the broad definition of lease must be addressed by statute or regulation. For example, a specific exclusion under paragraph 8 of subsection 168(j) might be enacted to limit the uncertain reach of the term “lease.” This exclusion might completely exclude a charitable organization from the disqualified lease provisions, or it may simply limit the definition of “lease” for charita-

167(k)(3)(B)).”

158. I.R.C. § 168(j)(5).

159. This would also eliminate the potential problems associated with “related entities” and “successors” under the proposed Technical Corrections Act. See supra note 117 and accompanying text.

160. Even though I.R.C. § 7701(e)(5) already excludes charitable organizations operating low-income housing the exclusion from the service contract analysis is narrow on its face and in the interpretation adopted by the Temporary Regulations. See supra note 138. Thus, if such a service contract or other arrangement, entered into by the charitable organization, is determined to be a “lease,” then such “lease” would not automatically lead to a finding of tax exempt use property under I.R.C. § 168(j). Perhaps loss of ITC is a sufficient cost for such arrangements.

161. For example, if a management contract, entered into between a taxable syndication and a nontaxable housing authority, were determined to be a lease under present law rules, it would not necessarily lead to a finding of tax exempt use property under I.R.C. § 168(j). Again, ITC would still be lost if applicable.

162. Notwithstanding the tax exempt entity leasing provisions, the structure of all real estate investment partnerships must by analyzed in light of the new regulations issued under I.R.C. § 704(b)(2). See supra note 106. For this reason, the I.R.S. will not issue ruling on I.R.C. § 704(b)(2). See supra note 148.

163. Such a limited exclusion would leave the tax exempt entity subject to the partnership provisions and the uncertainties raised by the Technical Corrections Act of 1985. See supra note 117 and accompanying text. Under such circumstances, additional regulations must be issued to define what is a “substantially similar activity” under I.R.C. § 168(j)(4)(E)(iii); this would permit use of some planning devices. See supra note 117.

164. This exclusion might read: “Paragraph 6 of this subsection shall not apply to any low-income housing (within the meaning of I.R.C. § 168(c)(2)(F)) if 1) such property is operated by or for an organization described in paragraph (3) or (4) of I.R.C. 501(c), and 2) at
VI. Conclusion

To put into perspective the problems and solutions of both providing low-cost shelter and promoting the participation of charities into low-income housing projects, it is important to remember that the participation of charities has provided only a fraction of the number of housing units that the private sector has independently made available. Even though the participation of charities in real estate syndications has only recently become possible, the need for their participation has never been greater. Future tax legislation should, therefore, address this unique and emerging opportunity to provide long term low-cost shelter, and amendments to the present legislation should be promulgated to provide additional incentives for the participation of such charities.

The possibilities and opportunities are many, but unfortunately beyond the scope of this comment. For the present, it is important

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165. The scope of the term “lease” might be limited as under § 7701(e)(5). See supra notes 134-35 and accompanying text. For example, an amendment or regulation to I.R.C. § 168(j)(6) might read: “The leasing of units of low-income residential property (within the meaning of I.R.C. § 168(c)(2)(F)), operated by or for an organization described in paragraph (3) or (4) of I.R.C. § 501(c), is not treated as use by or on behalf of such an organization.” (Compare the language of the legislative history. See supra note 135). This would limit the broad definition of lease and eliminate uncertainties arising from I.R.C. § 168(j)(6).

166. Some of the disincentives and uncertainties created by the 1984 Act may be alleviated by tax reform plans proposed by the House of Representatives. In particular, the new Incentive Depreciation System, replacing the ACRS method, (I.R.C. § 168), provides an election for entities controlled by tax exempt parties to escape characterization of partnership property as tax exempt property. In exchange, gain recognized on the disposition of a tax exempt entity's interest would be treated as unrelated business taxable income per I.R.C. § 511. H.R. 3838, 99th Cong., 1st Sess. § 201, 175 CONG. REC. 12,589 (1985). See also supra notes 71-77 and accompanying text. Such an election would effect the partnership in a similar fashion as the use of a taxable subsidiary in the partnership structure. See supra note 117. However, if the entire proposal was approved by the Senate and President in its present form, all real estate syndications would be drastically affected by the elimination of the “at risk” exception (I.R.C. § 465(c)(2)(D)) for a real property. H.R. 3838, 99th Cong., 1st Sess. § 401 (1985).

167. Future legislation could offer additional incentives for those arrangements providing long-term low-cost housing. Such amendments need not deplete or reduce any revenue collection; rather, coordinated restrictions might increase revenue collection. If, for example,
that a series of carefully-written and well-coordinated amendments to the present legislation eliminate the disincentives created by the 1984 Act so that charitable organizations might participate in low-income real estate syndications. The participation of such charities as general partner in these community development projects, creates opportunities to provide additional low cost shelter into an already depleted marketplace. Further, such participation ensures the continued existence of those units for low-income tenants. The need for such changes has never been greater. "The reality is that we have come to the end of a fifty-year cycle of institutional building. It is not enough to bemoan the past—we must structure the future." Because financial conservatism and federalism are no longer ideas for the future, but rather the reality of the 1980s, involvement of the private sector and charitable organizations in social programs presents a great hope for the future. Whether safe, decent and affordable housing will trickle down to or dry up for those less fortunate Americans will depend on how we structure that future.

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the recovery or recapture period were extended for those projects not including a tax exempt charity, then such an incentive would increase the participation of charities. The same restrictions might instead be made contingent to the resale of the units to eligible tenants at a fixed price (pursuant to I.R.C. § 167(k)) or resale of the limited partnership interests to the tax exempt general partner who would continue to supply low-income tenants with decent and affordable shelter.

It is interesting to note that the tax reform bill passed on Dec. 17, 1985 by the House of Representatives includes such a restrictive provision which would increase the incentive to invest in low-income housing. In particular, very low-income housing projects would be allowed a recovery period of 20 years, eight years less than the proposed recovery period for other forms of real property. See generally H.R. 3838, 99th Cong., 1st Sess. § 201, 175 CONG. REC. 12,589 (1985).
