Pushing the Limits: Nonprofit Guarantees in LIHTC Joint Ventures

Eric Mittereder

I. Introduction

Since Congress created the Low Income Housing Tax Credit (LIHTC)[1] more than twenty-five years ago, LIHTC has become the most important federal resource in financing the private development of affordable housing.[2] Both for-profit and nonprofit organizations leverage LIHTC to attract

1. The Low Income Housing Tax Credit is a credit against federal income tax, provided for under Internal Revenue Code, 26 U.S.C. § 42. It was initially enacted under the Tax Reform Act of 1986, Pub. L. No. 99-514, § 252, 99th Cong., 2d Sess. (1986). Unless otherwise indicated, all references to section numbers refer to provisions of the Code.

2. LIHTC accounts for a substantial majority of all affordable rental housing created in the United States today, having stimulated the production or rehabilita-

Eric Mittereder (emittereder@att-law.com) is an attorney at Applegate & Thorne-Thomsen, P.C. in Chicago. *This article provides a range of industry perspectives based on a series of discussions with legal practitioners. The following is a partial list of those who assisted in this research effort: Bennett Applegate, Lance Bocarsly, Glenn Graff, Matthew Hall, Erik Hoffman, Mark Kantor, Jonathan Klein, Kelly McLaughlin, Richard Power, Roberta Rubin, Michael Sanders, and Bill Skalitzky. The author expresses his appreciation for their comments. Nevertheless, the conclusions and findings expressed in this article are solely those of the author and not of the foregoing legal practitioners, Applegate & Thorne-Thomsen, P.C., or its clients.*

private equity investments, in which a for-profit investor enters into a joint venture and provides critical equity financing to develop and operate the affordable housing project. In order to obtain the equity needed to make such projects financially viable, project sponsors are generally required to provide certain guarantees to their for-profit equity investors. However, when the project sponsor is a nonprofit entity whose charitable purpose is to develop affordable housing, guarantees to for-profit entities may raise questions as to the nonprofit's tax-exempt status.[3]

Although the Internal Revenue Service (IRS) generally recognizes the development of affordable housing as a charitable activity, the IRS has also scrutinized engaging in charitable activities through a joint venture with a for-profit investor. A substantial body of IRS guidance and jurisprudence has developed to ensure that the nonprofit's obligations do not overly benefit the private investor or place the nonprofit's charitable assets at excessive risk in order to protect the private investment. To determine when such risk or private benefit becomes excessive, the IRS and several courts have emphasized the importance of terms reflecting an arm's-length negotiation. This body of law provides general rules applicable to affordable housing. However, the IRS has issued its most recent and detailed criteria for evaluating specific guarantees from a tax-exempt entity to a for-profit entity in a LIHTC joint venture in the form of informal, nonbinding guidance, starting in 2006 with an internal memorandum to IRS staff that is commonly referred to as the Urban Memo. The Urban Memo's approach represents a middle ground, recognizing that the existence of guarantees alone does not confer impermissible private benefit, but also imposing limits on certain guarantees in order to mitigate the risk to the tax-exempt entity's charitable assets.

Seven years after the Urban Memo, this article explores the relevance of changing market conditions to evaluating whether specific negotiated guarantees confer impermissible benefit on private investors. Since the collapse of housing and financial markets in 2008, investors have increased demands for guarantees and security, shifting greater risk to project guarantors. Nonprofits must balance the demands of tax-exempt status with the demands of equity providers in the current financial market, in which nonprofits compete with for-profit developers that can provide stronger guarantees unburdened by IRS limitations. Under current market conditions, to the extent that nonprofits push for strict adherence to the

---

tion of over 2.2 million apartment units since its inception in 1986, an average of nearly 100,000 units per year and far more than any other federal subsidy. *See* U.S. Dep't of Hous. & Urb. Dev., *Data Sets: Low-Income Housing Tax Credit*, *available at* www.huduser.org/portal/datasets/lihtc.html (updated as of Aug. 17, 2012).

3. Because this article focuses exclusively on questions involving a nonprofit's tax-exempt status, the terms "nonprofit" and "tax-exempt entity" are used interchangeably.

guarantee limitations described in the Urban Memo, investors may compensate by reevaluating their underwriting criteria, possibly resulting in reduced equity pricing or a smaller pool of potential investors for projects involving tax-exempt entities. Even if the terms of certain guarantees diverge from the standards set forth in the Urban Memo, the transaction may not necessarily create an impermissible private benefit, particularly if such guarantees are truly negotiated at arm's length and reflect prevailing industry practices. Indeed, if the nonprofit produces affordable housing and retains it long after the investor has exited the financing arrangement, these market requirements may be a reasonable exchange for the nonprofit to further its charitable purpose.

The first section of this article provides an overview of nonprofit participation in LIHTC partnerships and the need for certain guarantees, followed by the legal background for imposing limits on those nonprofit guarantees. After introducing the Urban Memo and other IRS guidance providing specific limitations on nonprofit guarantees, the first section analyzes this guidance's impact on nonprofit organizations negotiating transactions in a shifting financial market. The discussion draws from industry perspectives comparing the standards in the IRS guidance to current industry practices, based on both publications and interviews with legal practitioners, who represent a variety of geographic markets and interests in their roles as counsel for developers, investors, and syndicators.

The second section of the article applies this discussion to the three most contested guarantees that nonprofits provide to for-profit investors in LIHTC partnerships: (1) tax credit guarantees, (2) operating deficit guarantees, and (3) interest repurchase guarantees. The section identifies the issues raised by each particular guarantee and gauges the extent to which current industry practices overlap and diverge from the limitations proposed in the IRS guidance. These three pressure points in negotiations have produced several nuances in the terms of these guarantees, which vary in the degree to which they adhere to the standards set forth in the informal IRS guidance, but may nonetheless provide alternative mechanisms to minimize the risk to charitable assets. Some of these examples may be valuable improvements in developing formal guidance, in order to alleviate IRS concerns while enhancing flexibility to make business arrangements that provide investors with necessary security.

II. Legal Context and Industry Perspectives on Limiting Nonprofit Guarantees

This section begins with a brief overview of the joint venture as a financing structure in LIHTC transactions, followed by a legal background and the IRS's basis for limiting guarantees from nonprofits in those transactions. In doing so, this article builds on the work of Jonathan Klein and Roberta Rubin in a series of articles previously published in this *Journal*, the first of which provided a more extensive legal background and analysis on tax-exemption issues raised by nonprofit guarantees in the context of LIHTC transactions,[4] and the second of which examined the Urban Memo and its implications for practitioners in the area.[5] After briefly describing these tax-exemption issues as context and introducing subsequent guidance to the Urban Memo on limiting nonprofit guarantees, the remainder of the section turns to the impact such guidance has had on nonprofit organizations negotiating transactions in a shifting financial market, comparing prevailing industry practices to the standards set forth in the Urban Memo and its progeny.

A. Overview of a LIHTC Partnership and the Need for Nonprofit Guarantees

The statutory structure of the LIHTC program essentially ensures that tax-exempt entities participate in joint ventures with for-profit investors, and the investors have a legitimate desire for guarantees from the tax-exempt entities to secure their investments. In a typical LIHTC transaction, a project developer or sponsor enters into a joint venture with a for-profit investor, which provides a significant layer of equity financing to develop the project (often in addition to public and commercial debt financing).[6] Because a tax credit simply reduces a taxpayer's tax liability in a given year, LIHTC itself does not provide the equity necessary to finance a project's construction or operational costs. In particular, tax credits do not provide value to a tax-exempt organization, which has no federal income tax to offset.[7] Accordingly, the project sponsor will form a for-profit entity, generally a limited partnership or limited liability company taxable as a partnership, to own and operate the project and receive the allocation of tax credits.[8] The project developer or sponsor will either act directly as

4. *See* Roberta L. Rubin & Jonathan Klein, *Nonprofit Guaranties in Tax Credit Transactions*, 9 J. Affordable Housing & Community Dev. L. 302 (2000) [hereinafter Rubin & Klein, *Guaranties 2000*].

5. *See* Roberta L. Rubin & Jonathan Klein, *Nonprofit Guaranties in Tax Credit Transactions: A New Era?*, 15 J. Affordable Housing & Community Dev. L. 314 (2006) [hereinafter Rubin & Klein, *Guaranties 2006*].

6. For a comprehensive overview of structuring joint ventures between nonprofits and for-profits for LIHTC projects, see generally Michael Sanders, Joint Ventures Involving Tax-Exempt Organizations ¶ 13(1), (2), (6) (3d ed. 2011).

7. *See, e.g.*, Hous. Pioneers, Inc. v. Comm'r, 65 T.C.M. 2191 (1993) (acknowledging that "it is self evident that section 501(c)(3) organizations do not need business tax credits"), *aff'd*, 58 F.3d 401 (9th Cir. 1995).

8. The vast majority of entities are either a limited partnership or a limited liability company. Because both partnerships and limited liability companies may be treated as partnerships for federal income tax purposes, the issues of how guarantees can affect tax-exempt status are the same regardless of whether the entity is a partnership or limited liability company. Accordingly, all entities are referred to in this article as "partnerships" and "partners."

the general partner or form a single-purpose entity to serve as the general partner, while the for-profit investor enters as the limited partner. Because the owner partnership is a pass-through entity for tax purposes, the tax credits flow up to its partners. In this way, the LIHTC subsidy is essentially allocated to investors in exchange for investing private equity in low-income housing projects. The amount of equity an investor will provide is a negotiated term, which is loosely conceptualized in terms of price per dollar of credit. To maximize the equity generated by the credits, the investor limited partner typically takes a 99.99 percent partnership interest and receives the vast majority of the tax credits and related tax benefits, such as depreciation deductions.

Congress understood and intended that this ownership structure would take form.[9] The limited partner takes a majority ownership interest in the project because the Code requires that a taxpayer must own the LIHTC project in order to claim tax credits.[10] Otherwise, the joint venture structure essentially operates as a financing arrangement with many parallels to conventional loan financing. LIHTC projects generate tax credits over a ten-year period and are subject to a fifteen-year compliance period.[11] After claiming its credits, the typical investor limited partner will seek to exit the joint venture towards the end of the compliance period. In fact, the Code explicitly envisions that qualified nonprofits will have a right of first refusal to acquire the project back from the partnership for a minimal purchase price at the end of the compliance period, and nonprofit sponsors almost always obtain this right of first refusal.[12] Moreover, any profit motive the limited partner may have is necessarily subordinate to the project's compliance with the LIHTC requirements because the project's continued compliance drives the limited partner's ability to receive the tax credits.

Like any provider of financing in a typical real estate transaction, an equity investor in a LIHTC transaction will seek some form of security for its investment. Such investors contribute significant equity before the construction phase of the project is complete, projecting a long-term return that is contingent on sustained compliance with LIHTC requirements. From the perspective of security for this investment, the project partnership entity itself is generally a single-purpose entity with little capitalization beyond the investor's capital contribution. Until the construction phase is complete, the partnership often owns a dilapidated structure or

9. *See* Joint Committee on Taxation, General Explanation of the Tax Reform Act of 1986, at 154 (H.R. 3838, Pub. L. No. 99-514, 99th Cong., 2d Sess. (1987)), *available at* http://archive.org/stream/generalexplanati00jcs1087#page/n1/mode/2up.

10. *See id.* at 153.

11. I.R.C. §§ 42(f)(1) (ten-year "credit period"); 42(i)(1), (j) (fifteen-year "compliance period").

12. *See id.* § 42(i)(7).

vacant land as its sole asset. Given this lack of security, equity investors routinely obtain guarantees from the general partner, such as guarantees of construction completion, operating deficit guarantees, and tax credit compliance guarantees. Because the general partner is a single-purpose entity with its partnership interest as its sole asset, the equity investor generally seeks guarantees from the project sponsor as well.[13]

Moreover, for investors in LIHTC transactions, partnering with a tax-exempt sponsor may be desirable or even necessary for a number of reasons. Generally speaking, the Code requires each state to allocate a percentage of LIHTC each year to projects in which a "qualified nonprofit organization" owns an interest and materially participates in the project's development and operation, thus ensuring that a number of valuable LIHTC projects every year must include tax-exempt organizations in order to receive credits.[14] Moreover, certain states, such as California, require a nonprofit to serve as the general partner in order for an affordable housing project to obtain a property tax exemption, and nonprofits have relied on a combination of LIHTC and the property tax exemption in order to make projects economically feasible and attract equity investors.[15] On the one hand, nonprofits must provide some level of guarantees in order to compete for equity with for-profit developers that can provide such guarantees unburdened by tax law. On the other hand, if the project sponsor's tax-exempt status is necessary for the project to qualify for critical tax benefits such as LIHTC or a property tax exemption, the investor also has a major financial interest in ensuring the project sponsor retains its tax-exempt status. The investor may place limits on certain guarantees to mitigate the nonprofit's risk of assets, at least to the extent needed to prevent such guarantees from threatening the tax-exempt status of the nonprofit sponsor.

B. Legal Background for Limitations on Nonprofit Guarantees

A substantial body of IRS guidance and jurisprudence has evolved to evaluate joint ventures between nonprofits and for-profits from a tax-exemption perspective, particularly to ensure that the nonprofit's obliga-

13. For examples of practitioners providing a similar explanation of the need for guarantees from the nonprofit sponsor, *see* Rubin & Klein, *Guaranties 2000*, *supra* note 4, at 303; Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 315.

14. *See* I.R.C. § 42(h)(5) (providing that each state must allocate at least 10 percent of its annual credit allocation to such projects, and requiring that a "qualified nonprofit organization" must be tax-exempt, among other requirements).

15. For an overview of the property tax exemption in LIHTC transactions in California and New York, see Lance S. Bocarsly & Steven C. Koppel, *Real Property Tax Exemptions in Affordable Housing Transactions*, 2 J. AFFORDABLE HOUSING & COMMUNITY DEV. L. 12 (1993).

tions to its for-profit partner do not violate its charitable purpose.[16] Although several themes have developed, the IRS has expressed a particular dual concern that a nonprofit's guarantees could either overly benefit the for-profit limited partner or place the nonprofit's charitable assets at excessive risk in order to protect a private investment. To determine when a guarantee creates excessive risk or private benefit, the IRS and several courts have consistently focused on the "arm's-length negotiation" as a helpful fact and benchmark.

Congress created the LIHTC program against the backdrop of the seminal *Plumstead Theatre* case, which acknowledged that a joint venture with a for-profit could be consistent with a nonprofit organization's tax-exempt status and established the famous two-pronged analysis to evaluate: (1) under the charitable purpose test, whether the partnership advances the nonprofit organization's exempt purposes; and (2) under the private benefit test, whether the partnership arrangement permits the organization to act in furtherance of its exempt purposes rather than for the benefit of for-profit partners.[17] Although *Plumstead Theatre* did not specifically involve the affordable housing industry, numerous significant cases and IRS rulings have cited its analysis. Particularly relevant to this article, the Tax Court noted as helpful facts in its analysis that the arrangement was negotiated at arm's length and that the nonprofit was not obligated to secure the limited partner's investment out of its own assets.[18]

The *Housing Pioneers* case in the mid-1990s represented the first major application of these principles to LIHTC partnerships. The Tax Court held and the Ninth Circuit affirmed that a nonprofit did not qualify for tax exemption in this case because the partnership furthered a "substantial" nonexempt purpose and resulted in an impermissible benefit to private investors.[19] The IRS has since acknowledged that *Housing Pioneers* was an anomaly based on unusual facts,[20] but the case set forth important

16. For additional background on this body of law as it specifically relates to nonprofit guarantees in LIHTC partnerships, see Rubin & Klein, *Guaranties 2000*, *supra* note 4, at 303–08. For an even more comprehensive overview of the jurisprudence and IRS guidance evaluating joint ventures between for-profit and tax-exempt entities, including in the context of LIHTC projects, see generally SANDERS, *supra* note 6.

17. *See* Plumstead Theatre Soc'y v. Comm'r, 74 T.C. 1324 (1980), *aff'd*, 675 F.2d 244 (9th Cir. 1982).

18. *Id.* at 1333–34.

19. Hous. Pioneers, Inc. v. Comm'r, 65 T.C.M. 2191 (1993), *aff'd*, 58 F.3d 401 (9th Cir. 1995).

20. *See, e.g.*, *Recent Developments in Housing Regarding Qualification Standards and Partnership Issues*, IRS EXEMPT ORGANIZATIONS TECHNICAL INSTRUCTION PROGRAM FOR FISCAL YEAR 1996, Part B, at 39 (distinguishing *Housing Pioneers*, stating, "in effect, Pioneers sold its exempt status to for-profit organizations to enrich them and the founders of Pioneers. This was not a case where the exempt organization proposed

standards and sparked an ongoing debate over the extent to which the IRS will permit charitable organizations to place their tax-exempt assets at risk for the benefit of LIHTC partnerships. The Tax Court also emphasized that the business arrangements were not "negotiated at arm's length."[21]

In addition to *Plumstead Theatre* and *Housing Pioneers*, formal IRS guidance and recent cases in the health care context have generally confirmed the *Plumstead* two-prong test as the IRS methodology to evaluate partnerships between exempt organizations and for-profit entities. This body of law has increasingly focused on the nonprofit's level of *operational control* over the joint venture's activities as a key factor in determining whether the business arrangement furthers charitable purposes.[22] However, specific guarantees to private investors raise the two primary issues that the nonprofit's obligations do not overly benefit the private investor or place the nonprofit's charitable assets at excessive risk in order to protect the private investment.

C. Specific IRS Guidance on Limiting Nonprofit Guarantees

Although the case law and formal guidance described above provide general rules applicable to affordable housing developments, applying these broad rules to very specific negotiated terms in complex transactions has historically posed challenges for both private actors and the IRS. The IRS's most recent and direct attempts to develop detailed criteria for evaluating specific guarantees from a tax-exempt entity to a for-profit entity in LIHTC partnerships have taken the form of informal, nonbinding guidance.

The IRS examined specific guarantees to a limited partner in a LIHTC partnership in two key early examples, Private Letter Ruling No. 9731038[23] and an article entitled "Housing Partnership Agreements" in the Exempt Organizations Technical Instruction Program for Fiscal Year 2003 (2003 EO Report).[24] The IRS specifically scrutinized guarantees to

---

a new housing program and sought out investors in limited partnerships to fund the charitable housing. Pioneers did nothing to increase low-income housing stock.").

21. *Hous. Pioneers*, 65 T.C.M. at 2194.

22. *See* Rev. Rul. 98-15, 1998-1 C.B. 718; Redlands Surg. Serv. v. Comm'r, 113 T.C. 47 (1999), *aff'd*, 243 F.3d 904 (9th Cir. 2001); St. David's Health Care Sys. v. United States, 349 F.3d 232 (5th Cir. 2003). The jurisprudence focuses particularly on the nonprofit's control over a governing board or authority as a general partner to ensure that the partnership's activities serve the tax-exempt purpose as a priority to the limited partner's profit motives.

23. See Priv. Ltr. Rul. 9731038 (Aug. 1, 1997). An IRS private letter ruling is not authoritative legal precedent other than for the parties to whom the letter was issued, but PLRs still provide general guidance as to the IRS's analysis of a particular issue and have been cited in court as persuasive authority.

24. Mary Jo Salins & Robert Fontenrose, *Housing Partnership Agreements*, Exempt Organizations Technical Instruction Program for Fiscal Year 2003, at G-1

determine whether they allocate too much risk to the nonprofit sponsor and "overly benefit" the private investor, including tax credits, guarantees of completion or performance levels, and partnership interest repurchase obligations.[25] As a result, when the IRS processed applications for tax exemption from newly formed nonprofits that intended to participate in LIHTC partnerships, IRS agents applied additional scrutiny to guarantees of nonprofits in LIHTC partnerships. However, the IRS's lack of specific guidelines and ad hoc approach resulted in substantial delays and unpredictability in the exemption application process.[26]

In this historical context, the IRS issued specific guidance for limiting guarantees in LIHTC partnerships in 2006. Joseph Urban, then the Acting Director of the IRS Exempt Rulings and Agreements Division, issued an internal memorandum describing criteria for IRS staff to use in processing applications for tax exemption where the applicant proposes to participate in a LIHTC partnership (Urban Memo).[27] In 2007, the IRS circulated a new internal memorandum to formally supersede the Urban Memo (Choi Memo).[28] Although the Choi Memo makes a few minor changes, the vast majority is identical to the Urban Memo, including the provisions on guarantees that are most relevant to this article.[29] As of 2008, the Choi Memo was incorporated verbatim into the Internal Revenue Manual as Exhibit 7.20.4-6 (IRM Exhibit), which similarly provides processing

(determining that certain standard provisions could preclude exemption, and expressing concern that such guarantees could place the nonprofit's charitable assets at risk while providing more than incidental benefits to the for-profit investor) [hereinafter 2003 EO Report]. The 2003 EO Report is not an authoritative or binding pronouncement from the IRS. It provided informal guidance as a training document, and remained subject to modification by subsequent or more authoritative IRS pronouncements.

25. *Id*. at G-17–19.

26. *See* Ruth Sparrow, *IRS Releases Criteria for Tax-Exempt Status for Not-for-Profit General Partners of LIHTC Partnerships*, 17 Novogradac LIHTC Monthly Report, no. VI, June 2006, at 1. *See also* Nixon Peabody LLP, *IRS Releases New Internal Memorandum on Qualifying Housing Organizations for Tax-Exempt Status*, Tax Credit Alert, May 2006, at 1.

27. Joseph Urban, Memorandum for Manager, EO Determinations, Low Income Housing Tax Credit Limited Partnerships, Apr. 25, 2006, *available at* www.novoco.com/low_income_housing/news/archives/resource_files/UrbanMemo42406.pdf [hereinafter Urban Memo].

28. Robert Choi, Memorandum for Manager, EO Determinations, Low Income Housing Tax Credit Limited Partnerships, July 30, 2007, *available at* www.irs.gov/pub/irs-tege/lihtcp_choimemo_073007.pdf [hereinafter Choi Memo].

29. *Compare* Urban Memo, *supra* note 27, *with* Choi Memo, *supra* note 28. Specifically, the Choi Memo clarifies the Urban Memo requirement that the applicant identify a specific proposed housing project to be operated by the limited partnership, and the Choi Memo deletes the request at the end of the Urban Memo that a copy of a final limited partnership agreement be provided upon execution.

guides for exemption applications.[30] Accordingly, the Urban Memo, Choi Memo, and IRM Exhibit are referred to collectively at times as the "IRS Guarantee Guidance."[31]

This IRS Guarantee Guidance provides very specific standards for evaluating provisions in LIHTC partnership agreements, including limitations on a variety of guarantees to the investor limited partner. Although the IRS Guarantee Guidance explicitly applies to organizations that will serve directly as the *general partner* in a LIHTC partnership, arguably the same standards would apply in analyzing the risk to charitable exemption for a nonprofit sponsor guaranteeing the general partner's obligations for the benefit of the for-profit limited partner.[32] When the Urban Memo was released in 2006, some commentators viewed it as an important first step toward a safe harbor and formal guidance for tax-exempt organizations in pursuing their charitable purpose of developing affordable housing through LIHTC partnerships.[33] However, seven years later, this internal memorandum has not developed into a safe harbor or formal guidance relating to guarantees in LIHTC transactions. This lack of formal guidance continues to create uncertainty in the industry.

Practitioners have debated the likelihood that the IRS may apply this IRS Guarantee Guidance beyond a safe harbor for new tax-exemption applications and whether noncompliance poses a risk to an existing nonprofit of being audited or even having its tax-exempt status revoked. After the publication of the Urban Memo, several commentators predicted that these standards could impact all existing nonprofits that participate in LIHTC transactions and recommended that existing nonprofits follow the guidance when negotiating new partnership agreements.[34] However, several practitioners interviewed in 2012 argued that failing to strictly comply with the IRS Guarantee Guidance does not pose a significant threat to an existing nonprofit's tax-exempt status, based on both the procedural posture and the limited precedential value of these IRS internal memoranda.

30. Internal Revenue Manual § 7.20, Exempt Organizations Determination Letter Program, at Exhibit 7.20.4-6, Low Income Housing Tax Credit Limited Partnership Memorandum, Apr. 1, 2008, *available at* www.irs.gov/pub/irs-tege/ex_7_20_4_6_litcrev.pdf [hereinafter IRM Exhibit].

31. Citations refer to the IRM Exhibit with the understanding that the reference also reflects identical provisions in the Urban and Choi Memos.

32. *See, e.g.*, Rubin & Klein, *Guaranties 2006*, *supra* note 5.

33. *Id*. at 319–20.

34. *See* Michael Sanders & Jerome Breed, *IRS Issues Guidance for Nonprofit Organizations Involved in Low Income Housing*, Real Est. Fin., Aug. 2006. *See also* Sparrow, *supra* note 26, at 3. Notably, even at that time, practitioners did not recommend that existing nonprofits apply these standards retroactively or attempt to renegotiate specific provisions in previously executed documents.

The most significant arguments against a strict application of the IRS Guarantee Guidance focus on its procedural posture. The IRS Guarantee Guidance explains its purpose as providing a framework for IRS staff to process applications from organizations seeking tax exemption based on activities that include participating in LIHTC partnerships.[35] Several of the interviewed practitioners emphasized the procedural distinction between the IRS granting tax-exempt status to a newly formed entity based on its compliance with this framework, as opposed to revoking an existing entity's tax exemption for failure to comply with a checklist of limitations. Moreover, by its own terms, the criteria set forth in the IRS Guarantee Guidance are not rigid requirements or a mandatory formula that must be followed by every nonprofit negotiating its rights and obligations under a LIHTC partnership agreement. The IRS Guarantee Guidance specifically states that failure to meet a particular factor may not have adverse effects where the nonprofit "can otherwise describe how it will satisfy the particular concern described in the factor."[36] On its face, this IRS Guarantee Guidance appears to provide a safe harbor for newly formed nonprofits seeking to obtain tax-exempt status.[37] Even if this IRS Guarantee Guidance were applied to an existing nonprofit, many of the interviewed practitioners believe that failing to fall squarely within its criteria would not jeopardize the nonprofit's tax exemption. In contrast, commentators have argued that a partnership structured to comply with the IRS Guarantee Guidance will have a very strong position in either an initial determination or a future audit.[38]

A final significant argument that nonprofits need not strictly adhere to the IRS Guarantee Guidance is that it does not have the authority of formal IRS guidance. The Urban Memo, Choi Memo, and IRM Exhibit were each issued as internal communications to IRS examiners, and none of them was subject to the notice and comment requirements of a formal administrative rulemaking such as an IRS revenue ruling, revenue procedure, or treasury regulation. Moreover, senior IRS officials have publicly stated that the Urban Memo would not be binding on IRS staff in the event of an audit.[39] In contrast to the fundamental principles developed through case law and formal guidance as described above, the application of these principles to specific guarantees as set out in the IRS Guarantee Guidance only represents the views of certain IRS staff. Some of the practitioners interviewed believe that these interpretations are incorrect, and that if the

35. IRM Exhibit, *supra* note 30, at Introduction.

36. *Id*.

37. For examples of this interpretation, see Sanders, *supra* note 6, ¶ 13.6; Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320, 322; Nixon Peabody, *supra* note 26, at 3.

38. *See, e.g.*, Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320.

39. See *id*. at 319, citing to statements made at the annual conference sponsored by the ABA Forum on Affordable Housing and Homelessness on May 24–26, 2006, in Washington, D.C.

IRS ever attempted to revoke a 501(c)(3) status on this basis, the affected nonprofit could successfully appeal the determination.

Events in 2010 seemed to confirm the earlier warnings of IRS enforcement, as reports circulated about the use of the IRS Guarantee Guidance in audits of existing nonprofits in LIHTC partnerships.[40] An IRS examination letter cited the IRM Exhibit as grounds for its review of an existing nonprofit.[41] Contrary to the safe harbor interpretation of the IRS Guarantee Guidance, this examination letter omitted the introductory paragraphs in the IRM Exhibit, which provide its purpose and the safe harbor language. Instead, the examination letter simply listed the standards set forth in the IRM Exhibit, and stated that noncompliance with such standards could result in the revocation of tax-exempt status.[42]

That said, none of the interviewed practitioners were aware of an instance in which the IRS has revoked a 501(c)(3) tax-exempt status based on noncompliance with the IRS Guarantee Guidance, nor any Tax Court decision addressing or applying the criteria in this IRS Guarantee Guidance. Some noted that the IRS rarely revokes tax-exempt status for any reason other than failure to meet filing requirements. Until a tax-exempt entity's status is actually revoked, the prevailing industry view appears to be that noncompliance with this IRS Guarantee Guidance does not pose a significant threat to the tax-exempt status of existing nonprofits.

D. Applying the IRS Guarantee Guidance in a Shifting Market

Beyond an analysis of this particular IRS Guarantee Guidance's relevance to existing nonprofit organizations negotiating LIHTC partnership agreements, the recession and subsequent recovery have also raised more fundamental questions about the effectiveness of such specific standards for arm's-length transactions in a shifting financial market. The Urban Memo resulted from years of discussion between the IRS and a coalition of nonprofits involved in LIHTC projects.[43] Some practitioners speculate that the IRS publicized internal memoranda rather than using a formal rulemaking in order gauge the reaction of the LIHTC industry to this proposed set of practices. At the time it was issued in 2006, the Urban Memo largely reflected prevailing business practices in many partnership agreements, at least for well-represented nonprofits and some portion of the market.[44]

40. *See* Michael Novogradac, *Novogradac Report on Tax Credits*, Sept. 21, 2010, at 7, *available at* www.novoco.com/podcast/transcripts/092110.pdf.

41. IRS Exempt Organizations Examination Letter 3609 (Rev. 4-2003).

42. Compare *id. with* IRM Exhibit, *supra* note 30, at Introduction.

43. *See, e.g.*, Sanders & Breed, *supra* note 34; Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 319.

44. As reported by interviewed practitioners. *See also* Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320.

However, if the Urban Memo's standards were created based on the results of arm's-length negotiations, then changes in market conditions should be relevant to whether specific negotiated guarantees confer impermissible private benefit. The terms of guarantees depend to some extent upon the leverage of the developer or the investor in the transaction. A sophisticated market has developed around LIHTC as a financial product, in which equity investments are conceptualized in terms of a price per each dollar of credit. The Urban Memo was issued when there was strong competition between investors for LIHTC projects, and investors were making investments in LIHTC projects a rate of over $1 per credit.[45] At the time, nonprofit developers' counsel pushed to adjust provisions to fall within these guidelines, and many equity investors and syndicators were willing to abide by the market reality.

The housing and financial crisis in 2008 dramatically changed the LIHTC marketplace. Like investors and lenders in conventional real estate, investors in LIHTC transactions increased demands for guarantees and security. As the appetite of investors for tax credits shrank, market realities required developers to take on an increased share of risk in order to attract needed equity, and prevailing industry practices diverged further from the IRS Guarantee Guidance. Although the LIHTC market has improved significantly since 2008, investors have generally retained increased standards for guarantees and refused to return to pre-2008 guarantee terms.[46]

It is worth noting that industry standards are also geographically sensitive, and nonprofits generally appear to have greater negotiating leverage in markets such as New York and California. As discussed above, in states such as California this difference is partially based on requirements for a valuable property tax exemption.[47] To the extent that a percentage of project entities in each state must involve tax-exempt entities based on the Section 42 nonprofit set-aside, nonprofits also have greater leverage in areas where demand for LIHTC projects is particularly high.[48]

Even where nonprofits have greater leverage, they still compete with for-profit developers, which have been willing to take on greater risk in guarantees in order to secure equity under current market conditions. If nonprofits push to strictly comply with the IRS Guarantee Guidance,

45. *See id. See also* Novogradac & Co. LLP, *LIHTC Pricing Trends June 2010–Dec. 2012, available at* www.novoco.com/low_income_housing/facts_figures/index.php.

46. This foregoing description of market conditions was based on a consensus of interviewed practitioners.

47. See Part II.A (discussing the California requirement to include a tax-exempt entity as a general partner in order to obtain a property tax exemption).

48. Demand for LIHTC projects is particularly high around major financial hubs based on the Community Reinvestment Act, 12 U.S.C. § 2901, which generally requires certain financial institutions to invest in community development projects.

investors may compensate by reevaluating their underwriting criteria, possibly resulting in reduced equity pricing or a smaller pool of potential investors for projects involving tax-exempt entities.[49] Even practitioners who view this practice as inappropriate acknowledged that when there is insufficient demand for LIHTC projects, nonprofits may need to move further away from the IRS Guarantee Guidance in order to remain competitive with for-profit developers and secure investor interest.

Even if nonprofits take on greater risk today than they did when the Urban Memo was issued, departing from the letter of this informal guidance does not necessarily violate the core principles found in case law and formal IRS guidance. If a nonprofit produces affordable housing and retains it long after the investor has exited the financing arrangement, guarantees that exceed the limits found in the IRS Guarantee Guidance may nonetheless be viewed as a necessary business risk to further the nonprofit's exempt purpose. A nonprofit may further demonstrate its compliance with the formal doctrine by negotiating guarantees at arm's length that reflect prevailing industry practices among other developers.

Regardless of the legal debate over this IRS Guarantee Guidance, in reality nonprofit developers have used it in negotiations to raise their underlying concerns, and certain investors show sensitivity to nonprofit-based limitations. However, the consensus among the interviewed practitioners is that negotiations are ultimately driven more by market conditions, the economics of the particular transaction, and the relationship of the parties. Industry standards often overlap with the IRS Guarantee Guidance, but to the extent that they conflict, nonprofits are generally willing to risk noncompliance in order to enter the market.

III. Hot Button Guarantees in LIHTC Transactions

The first sections provided the legal background behind the IRS limits on guarantees in LIHTC transactions, and situated the IRS Guarantee Guidance in the context of current conditions in the LIHTC market. The remainder of this article applies this discussion to specific examples by using the three most contested guarantees that nonprofits provide to for-profit investors in LIHTC partnerships: (1) tax credit guarantees, (2) operating deficit guarantees, and (3) interest repurchase guarantees.

Each section explains the issues raised by the particular guarantee, the specific limitations proposed in the IRS Guarantee Guidance, and the extent to which current industry practices overlap and diverge from that IRS Guarantee Guidance. Because negotiated terms vary based on numerous factors, the aim of this section is to articulate ranges and broad trends in the industry for comparison against the IRS Guarantee Guidance. As

49. *See, e.g.*, Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320. Interviewed practitioners generally agreed with this view.

observed above, the IRS Guarantee Guidance acknowledges the possibility of deviating from the standards it sets, if the nonprofit can find another way to satisfy the IRS's concern addressed by that particular standard.[50] Based on this flexibility built into the IRS Guarantee Guidance, some commentators predicted after the Urban Memo that negotiations would produce a variety of the terms for these guarantees, which vary in the degree to which they adhere to the standards set forth in the IRS Guarantee Guidance, but may nonetheless provide alternative mechanisms to minimize the risk to charitable assets.[51] These three pressure points in negotiations have produced several creative solutions. Some of these examples may be valuable improvements in developing formal guidance, in order to alleviate IRS concerns while enhancing flexibility to make business arrangements that provide investors with necessary security.

A. Operating Deficit Guarantees

LIHTC partnership agreements generally require the project sponsor to guarantee payments if the project continues to run operating deficits and cannot pay its expenses. However, commentators have observed that operating deficits are to some extent dependent on market forces outside the sponsor's reasonable control, such as expenses and the rental market.[52] By accepting unlimited operating risk, a nonprofit guarantor could be viewed as securing its for-profit partner's return to the detriment of the charitable mission. When the IRS initially attempted to apply the prior established private benefit doctrine to this very specific issue of operating deficit guarantees, the 2003 EO Report flatly prohibited any provision requiring the nonprofit to guarantee a return of capital to the investor partner if certain project performance levels are not met.[53] The 2003 EO Report distinguished guarantees to cover potential failures due to the negligence of the nonprofit but asserted that all investments must carry some degree of risk, and that if the nonprofit bears all of the project's operating risk then the benefit to the limited partner is more than incidental.[54]

The IRS Guarantee Guidance provided a more flexible stance by explicitly permitting operating deficit guarantees by a nonprofit to a private investor, provided that the agreement limits (1) the amount and/or (2) the duration of such guarantee. The language implies that only one limitation is required, but both are encouraged.[55] In practice, limiting both the amount and duration of operating deficit guarantees was already common in LIHTC partnership agreements when the Urban Memo was issued

50. *See* IRM Exhibit, *supra* note 30, at Introduction.
51. Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 322.
52. Rubin & Klein, *Guaranties 2000*, *supra* note 4, at 310.
53. *See* 2003 EO Report, *supra* note 24, at G-18.
54. *Id*.
55. IRM Exhibit, *supra* note 30, § 5(c).

in 2006.[56] Such limitations continue to reflect prevailing business practices, with certain variations in the details and extent of those limits.

With respect to the *amount* limit, the IRS Guarantee Guidance provides that an operating deficit guarantee must be capped at six months of operating expenses, including debt service.[57] The industry has largely adopted this general standard. The greater source of contention is how to define the debt service coverage ratio (DSCR), which serves as the benchmark for the amount of cash available for the project to meet its interest and principal payments. A DSCR at 1.0 represents exactly enough cash flow to cover the project's loan payments. Investors typically seek a DSCR higher than 1.0, which would indicate a cash buffer beyond the bare minimum needed to cover its debt service. The IRS Guarantee Guidance does not define DSCR, but the interviewed practitioners reported a range between 1–1.25. Practitioners emphasized that trends toward 1.2 represent caution in financial projections under current market conditions because actually maintaining a 1.2 DSCR indicates a very healthy affordable housing project.

With respect to the *term* limit, the IRS Guarantee Guidance provides that an operating deficit guarantee should run for not more than five years from the date a project first achieves so-called break-even operations.[58] The IRS Guarantee Guidance defines break-even as the date when the project achieves 95 percent occupancy *and* operational revenues equal all accumulated operational costs of the project for three consecutive months after construction completion.[59] Moreover, the nonprofit may enter into the agreement only after verifying that the project is expected to reach break-even operations within a reasonable period after construction completion.[60] These basic limitations also generally coincide with industry practices. Operating deficit guarantees typically run for approximately three to five years after the achievement of break-even or some other similar benchmark of stabilized operations.[61] Moreover, developers routinely conduct market studies and other due diligence to manage project risk, and investors typically require such due diligence as prudent business practice.

However, determining the precise threshold to terminate the guarantee produces more variation and room for creativity. For example, many investors also require the project to maintain a minimum DSCR through-

56. *See* Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320–21.

57. IRM Exhibit, *supra* note 30, § 5(c)(2).

58. *Id.* § 5(c)(1).

59. *Id.* § 5(c)(1)(i)–(ii). This is calculated on a cash basis and in accordance with the project and loan documents.

60. *Id.* The verification can be by conducting a market study or other due diligence.

61. As reported by interviewed practitioners. For more on common terms when the Urban Memo was issued, see also Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320–21.

out the term of the guarantee as an additional condition to terminate, which could extend the guarantee's term further. A minority of practitioners reported requesting an average DSCR over the guarantee period rather than requiring a minimum over a number of consecutive months, voicing the concern that one poor month should not extend the guarantee if the project has otherwise remained stable over a long-term period.

Beyond the limits addressed in the IRS Guarantee Guidance, in practice the project's operating reserve represents another major deal term impacting the operating deficit guarantee. The IRS Guarantee Guidance simply permits an operating reserve to be established based on projected operating expenses, but offers no further guidance on how such reserve should affect the nonprofit's guarantee.[62] In practice, the reserve exists to cover operating deficits, so the sponsor is often allowed to access this operating reserve to pay down operating deficits. Limited partners insist on consent rights as a matter of tracking the flow of funds, but such consent may not be unreasonably withheld.

Two operating deficit reserve issues may be worth addressing in future IRS guidance. First, a project sponsor often has the right to deplete the project's operating reserve before fulfilling its guarantee and funding operating deficits out of pocket. However, a significant minority of investors reportedly take the opposite approach, requiring payments from the general partner or guarantor up to a certain amount before tapping into the operating reserve. Second, it has become relatively standard practice to require that the operating reserve must be funded, either fully or at least partially, to an established level as an additional condition to terminating the operating guarantee. By dipping into the operating reserve, a nonprofit sponsor also extends the length of the guarantee. Accordingly, even if an agreement provides for a five-year term in compliance with the IRS Guarantee Guidance, that term limit is often illusory. This arrangement may be a reasonable trade-off nonetheless because the nonprofit protects its own assets in exchange for extending a contingent liability into the future.

B. Tax Credit Guarantees

LIHTC partnership agreements also generally include so-called tax credit adjuster provisions, which function to cure the investor's loss of benefits in the events of a permanent reduction in the amount of credits, a delay in the timing of credits where the projected tax credits for the first year must be taken in later years, or recapture of credits that have already been taken.[63] Credit adjuster provisions generally account for this loss by reducing the investor's capital contributions, but if the reduction is greater than the remaining equity to be paid, then such provisions may require the general partner or its nonprofit guarantor to fund a payment to the

62. IRM Exhibit, *supra* note 30, § 5(c)(2).
63. *Id.* § 5(d).

investor to make up the shortfall. The IRS has expressed concerns about tax credit adjuster guarantees similar to operating deficit guarantees. In the 2003 EO Report, the IRS initially prohibited any provision requiring the nonprofit to guarantee the tax credit itself to the investor as opposed to a compliance guarantee, a provision that only obligates the general partner to make all reasonable efforts to ensure that the partnership operates in a manner to qualify for tax credits.[64] The 2003 EO Report reasoned that guaranteeing the tax credit itself effectively guarantees the investor's return on investment, which goes beyond a general partner's fiduciary duty and creates an impermissible private benefit to the investor.[65]

As with operating deficit guarantees, the IRS Guarantee Guidance mitigated this stance by explicitly permitting tax credit guarantees, but only if the agreement limits the credit adjuster payments by (1) making them repayable upon sale or refinancing and/or (2) capping the amount of the payments. The language implies that only one limitation is required but both are encouraged.[66] In practice, nonprofits have successfully limited tax credit adjuster guarantees in a variety of ways, and the IRS Guarantee Guidance represents two relatively common approaches.[67]

Making the credit adjuster payments repayable costs the investor little, while theoretically providing the nonprofit with a means to recoup the amount advanced under that guarantee upon the sale or refinancing of the property, with priority distribution or repayment of residual assets over the other partners.[68] The IRS Guarantee Guidance suggests two specific mechanisms to make the credit adjuster payment repayable, by treating the payment either (1) as a capital contribution or (2) as a loan to the partnership.[69] Both of these specific mechanisms appear to be used in practice with relative frequency, as some practitioners reported treating a credit adjuster payment as a capital contribution to the partnership, while others reported structuring the credit adjuster payment as a non-interest-bearing loan to the partnership, which may be repaid out of either cash flow or sale/refinancing proceeds. However, some investors resist recharacterizing tax credit adjuster payments altogether. It is also worth noting that building this protection into the partnership agreement does not guarantee the nonprofit will actually be repaid. For example, the eventual sale or refinance may leave insufficient proceeds to repay the nonprofit, particularly if the nonprofit's payment priority is below the partnership's other creditors.

64. 2003 EO Report, *supra* note 24, at G-19.

65. *Id.*

66. *See* IRM Exhibit, *supra* note 30, § 5(d).

67. As reported by interviewed practitioners. For more on common terms when the Urban Memo was issued, see Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320.

68. *Id.*

69. IRM Exhibit, *supra* note 30, § 5(d)(2).

As opposed to making the guarantee repayable, capping the amount of the tax credit guarantee may be a more effective method to limit the nonprofit's exposure of its charitable assets. The IRS Guarantee Guidance provides that credit adjuster payments must be capped at the aggregate amount of fees that the nonprofit and its affiliates are entitled to receive in connection with the project.[70] In practice, this mechanism also arguably reflected market conditions, at least at the time of the Urban Memo in 2006, when many equity investors were accepting tax credit guarantee caps.[71] However, caps on tax credit guarantees have always been hotly negotiated, and several practitioners reported that such caps have become increasingly rare in the current market. Still, some developers' counsel reported continuing success in capping tax credit guarantees in the current market, particularly where nonprofits have greater negotiating power such as when tax-exempt participation is needed to qualify for a property tax exemption. Nonprofits have also succeeded in limiting the amount of the tax credit guarantee to the developer fee, irrespective of other fees payable to the general partner or its affiliates, which is an even more aggressive cap than the IRS requires.

Aside from capping the amount of tax credit adjuster guarantees or making them repayable as set forth in the IRS Guarantee Guidance, prevailing business practices already provide two additional limitations on the exposure of the guarantor's assets. First, a significant mechanism limits the trigger events under which the nonprofit could have to make a tax credit guarantee payment in the first place. This will be discussed further in the following section on repurchase obligations. Second, the investor can pull funds directly from the project before seeking a cash payment from the nonprofit. Because the investor generally makes a capital investment in the partnership in a series of installments over time, an investor will generally simply reduce its own capital contributions to account for the credit adjuster. The IRS Guarantee Guidance sanctions this practice by explicitly focusing on direct cash payments from the nonprofit and excluding "reductions to the investor's capital contributions" from its proposed limitations.[72] Of course, this mechanism alone only protects the nonprofit's assets to the extent that sufficient capital contributions remain outstanding.

70. *Id*. § 5(d)(1). Note that a literal reading of the cap requirement would apply separately to each adjuster provision, thus allowing the total credit adjuster payments to exceed any expected payments to the nonprofit. However, this result cannot be intended, given that it would allow significant financial exposure to the charitable assets that the IRS Guarantee Guidance was intended to protect. *See* Scott Fireison, *Low Income Housing Tax Credits and Mixed Finance for Public Housing and Nonprofits, Mark-to-Market and FHA Lending*, AFFORDABLE HOUSING, 2006, *available at* www.pepperlaw.com/publications_update.aspx?ArticleKey=761.

71. *See also* Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 320.

72. IRM Exhibit, *supra* note 30, § 5(d).

Finally, a variety of other creative solutions to provide investors with additional security could also potentially be used to limit the exposure of a nonprofit guarantor's assets. For example, outstanding tax credit adjuster payments are generally payable out of available cash flow from the project. Practitioners reported that a significant minority of investors are willing to limit the tax credit adjuster guarantee after the project reaches break-even operations or another benchmark,[73] at which point the nonprofit's assets may become protected and any credit adjusters must be paid out of available cash flow from the project. Similarly, the nonprofit almost always has a right to acquire the project at the end of the LIHTC compliance period,[74] and outstanding tax credit adjuster payments are generally also incorporated into the purchase price. The right of first refusal could potentially be used to defer payments until the end of the fifteen-year tax credit compliance period, when the nonprofit could choose whether to make the payment or forfeit its right to purchase the property.[75]

In practice, a combination of these methods is generally incorporated into partnership agreements, which may operate to further limit a guarantee or even provide an alternative means of satisfying the IRS's key concerns. Even when a guarantee is "unlimited" by the standards of the IRS Guarantee Guidance, such combinations provide flexibility for an investor to seek security while remaining sensitive to the financial health of the nonprofit and the project.

C. Interest Repurchase Guarantees

In addition to the nonprofit's guarantees to make payments to the investor to cover operating deficits or shortfalls in tax credits, the so-called atom bomb remedy in LIHTC partnership agreements is the general partner's obligation to repurchase the investor's partnership interest. This repurchase obligation is generally reserved for a serious failure to meet certain fundamental requirements relating to the viability of the project.[76] Repurchase guarantees present a third major concern for the IRS, and in response the IRS Guarantee Guidance provides for limits on the repurchase obligations of nonprofits.

According to the IRS Guarantee Guidance, the repurchase price must be limited to the amount of the investor's capital contributions.[77] On this issue, the IRS Guarantee Guidance did not reflect prevailing business practice, and its limitations have not become a guiding industry principle. Nearly all investors insist on recovering some amount over their original capital contributions, in compensation for their effort, opportunity cost,

73. As discussed in the prior section on operating deficit guarantees.

74. This is also required under IRM Exhibit, *supra* note 30, § 5(e).

75. Practitioners did not report the right of first refusal currently being used in this way.

76. *See* IRM Exhibit, *supra* note 30, § 5(f).

77. *Id.*

and the time value of money.[78] Approaches to conceptualizing this compensation vary. A common repurchase price equals the capital contributions plus interest within a range of 5 percent to 10 percent.[79] Investors, particularly large national banks, are increasingly attempting to include penalties in addition to the interest, such as payments for costs and tax impacts. For example, a so-called boost percentage would also incorporate the investor's internal rate of return into the repurchase price. Such provisions effectively guarantee a certain after-tax return to the investor even if the project fails. At the moment, many practitioners reported that general partners are rejecting such additions to the repurchase price beyond interest. At most, investors tend to receive either interest or penalties.

Although the repurchase price is always hotly contested, since any repurchase presents a significant risk to the nonprofit's assets, the key workaround solutions focus on avoiding the repurchase obligation in the first place. The first strategy limits the type of events that trigger the repurchase obligation. The IRS Guarantee Guidance limits these to serious failures to meet fundamental project requirements, including failure to qualify for the LIHTC in whole or substantial part, failure to obtain permanent financing, and/or commencement of foreclosure proceedings on the construction loan.[80] In practice, repurchase obligations are often limited to so-called cliff events that would result in the investor completely failing to receive the benefit of its bargain. The nature of these events generally also limits them in time to the construction and lease-up periods, similar to a construction loan, so that very few events could trigger a repurchase obligation by the time the project's operations have stabilized.

The second strategy limits the repurchase obligation to events within the developer's control. As an industry standard for nonprofits and for-profits alike, events outside of the general partner's control, such as a change in tax law, casualty, or condemnation events, will not trigger repurchase obligations. Moreover, for failures to meet a requirement due to the act or omission of the investor, the investor always takes responsibility. This effort also bleeds into efforts to limit tax credit guarantees. If a loss in LIHTC is due to a change in tax law, investors will often accept the loss, or at least limit the obligation to a tax credit adjuster payment out of available project cash flow. As a related point, to the extent that a default that could trigger such guarantees is curable, developers will often push hard and succeed in obtaining reasonable notice and cure protections. Tailoring these guarantees more closely to scenarios in which the general partner has actually failed its fiduciary duty directly addresses one of the original and primary concerns of the 2003 EO Report.

---

78. Rubin & Klein, *Guaranties 2006*, *supra* note 5, at 321.

79. The interest may also be tied to the prime rate plus four to five points, which also falls within this range.

80. *See* IRM Exhibit, *supra* note 30, § 5(f).

IV. Conclusion

Prevailing industry practices for guarantees to investors in LIHTC transactions often diverge from the standards set in the Urban Memo, Choi Memo, and IRM Exhibit. Guarantees that exceed the limits found in this IRS Guarantee Guidance may nonetheless be viewed as a necessary business risk to further the nonprofit's exempt purpose of providing affordable housing, particularly if such guarantees are truly negotiated at arm's length and reflect prevailing industry practices. In order to determine whether the terms of these guarantees actually confer impermissible private benefit, both practitioners and IRS examiners should pay special attention to substance over form.

As a first overall observation, a particular provision may satisfy the IRS Guarantee Guidance in form but raise similar concerns in substance. As noted above, capping an operating deficit guarantee in time and amount may be illusory if the benchmarks are excessively difficult to meet. Similarly, specific provisions must be analyzed within the context of the entire partnership agreement to understand how those provisions interrelate. For example, capping tax credit guarantees would not necessarily limit the risk to a nonprofit's assets if any of the events could also trigger a repurchase obligation.

Conversely, even if particular provisions deviate from the IRS Guarantee Guidance in form, prospective guarantee rights in the partnership agreement are not necessarily representative of how disputes will be resolved in practice. Several practitioners emphasized that many factors control whether investors will ever exercise the guarantee. Particularly given a long-term relationship with the nonprofit, investors will often work out an arrangement that is sensitive to the financial health of the nonprofit and the project. The investor may even have a profit motive to protect the nonprofit's assets in order to preserve its investment in concurrent or future deals. A nonprofit may also choose to invest its own assets and stand behind an affordable project, even if it is not required to do so by the partnership agreement.

Ultimately, the IRS should issue guidance through a formal rulemaking to reconcile tax-exempt private benefit concerns with the statutory structure of the LIHTC program, which clearly envisions that nonprofits will continue to be involved in LIHTC projects, and that they will use the LIHTC to attract private capital from for-profit, tax-paying investors. Such guidance should provide a clear roadmap for both applicants for tax-exempt status and existing tax-exempt entities that are actively negotiating deal terms in a shifting market. Hopefully such guidance will both provide a legal safe harbor and retain flexibility for parties to negotiate alternative business arrangements in good faith, in order to allow for a variety of terms in guarantees that provide investors with necessary security while adequately protecting the assets of charitable entities. Such guidance would empower charitable entities to use LIHTC to develop affordable housing without risking their tax-exempt status.